

**DESCRIPTION OF THE
“SMALL BUSINESS AND FARM ECONOMIC RECOVERY ACT”**

Scheduled for a Markup
By the
SENATE COMMITTEE ON FINANCE
on
September 19, 2002

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION



September 17, 2002
JCX-88-02

CONTENTS

	<u>Page</u>
INTRODUCTION	1
A. Provisions to Promote Small Business Investment.....	2
1. Increase in section 179 expensing.....	2
2. Recovery period for depreciation of certain leasehold improvements	3
3. Exclusion of certain indebtedness of small business investment companies from acquisition indebtedness	4
B. Provisions to Simplify Small Business Taxation.....	6
1. Disclosure of tax information to facilitate combined employment tax reporting (STAWRS).....	6
2. Increased deduction for business meals while operating under Department of Transportation hours of service limitations	7
C. Provisions Relating to Tax Relief for Farmers, Ranchers and Fishermen.....	9
1. Farm, Fish and Ranch Risk Management accounts	9
2. Exclusion of rental income from self-employment tax.....	10
3. Exclusion of conservation reserve program payments from self-employment tax.....	11
4. Exemption of agricultural bonds from private activity bond volume limits	12
5. Coordinate farmers and fisherman income averaging and the alternative minimum tax.....	13
6. Modify cooperative marketing rules to include value added processing involving animals	13
7. Extend declaratory judgment procedures to farmers' cooperative organizations	14
8. Payment of dividends on stock of cooperatives without reducing patronage dividends ..	15
9. Special rules for livestock sold on account of weather-related conditions	15
10. Farmer optional method for computing net earnings from self-employment	17
11. Capital gains treatment to apply to outright sales of timber by landowner	19
12. Expensing of certain reforestation expenditures	20
D. Provisions Relating to S Corporation Reform and Simplification.....	21
1. Maximum number of shareholders of an S corporation	21
2. Termination of election and additions to tax due to passive investment income	21
3. Treatment of S corporation shareholders	22
4. Provisions relating to banks	23
5. Qualified subchapter S subsidiaries.....	25
E. Provisions to Promote Economic Development and Rural Investment.....	26
1. Accelerated depreciation for investment in high out-migration counties.....	26
2. Treatment of expenses of rural letter carriers' vehicles	29
3. Broadband internet access tax credit.....	30

4. Broadband provisions relating to housing: modification to the low-income housing credit allocation criteria.....	31
5. Modify qualified zone academy bond provisions to provide similar bonds for the construction of schools for the Bureau of Indian Affairs of the Department of the Interior.....	32
6. Qualified small business stock.....	37
7. Modification to the work opportunity tax credit.....	38
8. Treatment of new markets venture capital companies for the new markets tax credit.....	39
F. Provisions to Simplify Excise Taxes	41
1. Simplification of excise tax imposed on bows and arrows.....	41
2. Custom gunsmiths.....	41
3. Repeal special occupational taxes on producers and marketers of alcoholic beverages ..	42
4. Treat tribal governments the same as State governments for purposes of the Federal wagering excise and occupational taxes	43
G. Rate Reduction For Asbestos-Related Settlement Funds	45
H. Provisions to Discourage Corporate Expatriation.....	47
1. Tax treatment of inversion transactions	47
2. Reinsurance agreements	52
3. Excise tax on stock compensation of insiders of inverted corporations	53
I. Provisions to Curtail Tax Shelters	58
1. Clarification of the economic substance doctrine	58
2. Penalty for failure to disclose reportable transactions	64
3. Modifications to the accuracy-related penalties for listed transactions and reportable transactions having a significant tax avoidance purpose	68
4. Penalty for understatements from transactions lacking economic substance	72
5. Modifications to the substantial understatement penalty.....	75
6. Tax shelter exception to confidentiality privileges relating to taxpayer communications	76
7. Disclosure of reportable transactions by material advisors	76
8. Investor lists and modification of penalty for failure to maintain investor lists	80
9. Actions to enjoin conduct with respect to tax shelters and reportable transactions	81
10. Understatement of taxpayer's liability by income tax return preparer	82
11. Penalty for failure to report interests in foreign financial accounts	82
12. Frivolous tax returns and submissions	84
13. Regulation of individuals practicing before the Department of the Treasury.....	84
14. Penalties on promoters of tax shelters.....	85
15. Extend statute of limitations for certain undisclosed transactions	86
16. Deny deduction for interest paid to IRS on underpayments involving certain tax-motivated transactions	87
17. Modify section 162(f) for certain fines and penalties.....	88
18. Authorize additional \$300 million per year to the IRS to combat abusive tax avoidance transactions	89

J. Other Provisions.....	90
1. Affirmation of consolidated return regulation authority.....	90
K. Provisions Relating to Fair Taxation of Executive Compensation.....	95
1. Taxation of deferred compensation provided through offshore trusts	95
2. Repeal of limitation on issuance of Treasury guidance regarding nonqualified deferred compensation	97
3. Required wage withholding at top marginal rate for supplemental wage payments in excess of \$1 million	100

INTRODUCTION

The Senate Committee on Finance has scheduled a markup on September 17, 2002, of the “Small Business and Farm Economic Recovery Act.” This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of the “Small Business and Farm Economic Recovery Act.”

¹ This document may be cited as follows: Joint Committee on Taxation, *Description of the “Small Business and Farm Economic Recovery Act”* (JCX-88-02), September 17, 2002.

A. Provisions to Promote Small Business Investment

1. Increase in section 179 expensing

Present Law

Present law provides that, in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to \$24,000 (\$25,000 for taxable years beginning in 2003 and thereafter) of the cost of qualifying property placed in service for the taxable year (sec. 179). In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The \$24,000 (\$25,000 for taxable years beginning in 2003 and thereafter) amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000.

Additional section 179 incentives are provided with respect to a qualified property used by a business in the New York Liberty Zone (sec. 1400(f)) or an empowerment zone (sec. 1397A). Such a business may elect to deduct an additional \$35,000 of the cost of qualified property placed in service. In addition, the phase-out range is applied by taking into account only 50 percent of the cost of qualified zone property that is section 179 property.

The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.

Description of Proposal

The proposal provides that the maximum dollar amount that may be deducted under section 179 is increased to \$30,000 for property placed in service in taxable years beginning after December 31, 2002.² In addition, for taxable years beginning after December 31, 2006, the maximum dollar amount that may be deducted under section 179 and the present-law \$200,000 limit will be indexed for inflation on an annual basis.³ As under present law, no general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.

² Increases to this amount correspondingly increase the annual amount of qualified property that may be deducted by a business located in the New York Liberty Zone or an empowerment zone.

³ The maximum amount of qualified property that a taxpayer may deduct is indexed for inflation in \$1,000 increments while the present-law \$200,000 limit is indexed for inflation in \$10,000 increments.

Effective Date

The proposal applies to taxable years beginning after December 31, 2002.

2. Recovery period for depreciation of certain leasehold improvements

Present Law

Depreciation of leasehold improvements

Depreciation allowances for property used in a trade or business generally are determined under the modified Accelerated Cost Recovery System (“MACRS”) of section 168. Depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease (sec. 168(i)(8)).⁴ This rule applies regardless of whether the lessor or the lessee places the leasehold improvements in service.⁵ If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service (secs. 168(b)(3), (c)(1), (d)(2), and (i)(6)).⁶

Qualified leasehold improvement property

The Job Creation and Worker Assistance Act of 2002⁷ generally provides an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified property

⁴ The Tax Reform Act of 1986 modified the Accelerated Cost Recovery System (“ACRS”) to institute MACRS. Prior to the adoption of ACRS by the Economic Recovery Act of 1981, taxpayers were allowed to depreciate the various components of a building as separate assets with separate useful lives. The use of component depreciation was repealed upon the adoption of ACRS. The Tax Reform Act of 1986 also denied the use of component depreciation under MACRS.

⁵ Former sections 168(f)(6) and 178 provided that, in certain circumstances, a lessee could recover the cost of leasehold improvements made over the remaining term of the lease. The Tax Reform Act of 1986 repealed these provisions.

⁶ If the improvement is characterized as tangible personal property, ACRS or MACRS depreciation is calculated using the shorter recovery periods and accelerated methods applicable to such property. The determination of whether improvements are characterized as tangible personal property or as nonresidential real property often depends on whether or not the improvements constitute a “structural component” of a building (as defined by Treas. Reg. sec. 1.48-1(e)(1)). See, for example, *Metro National Corp.*, 52 TCM (CCH) 1440 (1987); *King Radio Corp.*, 486 F.2d 1091 (10th Cir. 1973); *Mallinckrodt, Inc.*, 778 F.2d 402 (8th Cir. 1985) (with respect to various leasehold improvements).

⁷ Pub. Law No. 107-147.

placed in service before 2005. Qualified property includes qualified leasehold improvement property. For this purpose, qualified leasehold improvement property is any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met. The improvement must be made under or pursuant to a lease either by the lessee (or sublessee), or by the lessor, of that portion of the building to be occupied exclusively by the lessee (or sublessee). The improvement must be placed in service more than three years after the date the building was first placed in service. Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building.

Treatment of dispositions of leasehold improvements

A lessor of leased property that disposes of a leasehold improvement which was made by the lessor for the lessee of the property may take the adjusted basis of the improvement into account for purposes of determining gain or loss if the improvement is irrevocably disposed of or abandoned by the lessor at the termination of the lease. This rule conforms the treatment of lessors and lessees with respect to leasehold improvements disposed of at the end of a term of lease.

Description of Proposal

The proposal provides that 25-year property for purposes of the depreciation rules of section 168 includes qualified leasehold improvement property. The straight-line method is required to be used with respect to qualified leasehold improvement property.

Qualified leasehold improvement property is defined as under present law for purposes of the additional first-year depreciation deduction (sec. 168(k)) with the following modification. If a lessor makes an improvement that qualifies as qualified leasehold improvement property such improvement shall not qualify as qualified leasehold improvement property to any subsequent owner of such improvement. An exception to the rule applies in the case of death and certain transfers of property that qualify for non-recognition treatment.

Effective Date

The proposal applies to qualified leasehold improvement property placed in service after September 11, 2004 except if such qualified leasehold improvement qualifies for the additional depreciation provided by section 168(k).

3. Exclusion of certain indebtedness of small business investment companies from acquisition indebtedness

Present Law

In general, an organization that is otherwise exempt from Federal income tax is taxed on income from a trade or business that is unrelated to the organization's exempt purposes. Certain types of income, such as rents, royalties, dividends, and interest, generally are excluded from unrelated business taxable income except when such income is derived from "debt-financed

property.” Debt-financed property generally means any property that is held to produce income and with respect to which there is acquisition indebtedness at any time during the taxable year.

In general, income of a tax-exempt organization that is produced by debt-financed property is treated as unrelated business income in proportion to the acquisition indebtedness on the income-producing property. Acquisition indebtedness generally means the amount of unpaid indebtedness incurred by an organization to acquire or improve the property and indebtedness that would not have been incurred but for the acquisition or improvement of the property.⁸ Acquisition indebtedness does not include, however, (1) certain indebtedness incurred in the performance or exercise of a purpose or function constituting the basis of the organization’s exemption, (2) obligations to pay certain types of annuities, (3) an obligation, to the extent it is insured by the Federal Housing Administration, to finance the purchase, rehabilitation, or construction of housing for low and moderate income persons, or (4) indebtedness incurred by certain qualified organizations to acquire or improve real property. An extension, renewal, or refinancing of an obligation evidencing a pre-existing indebtedness is not treated as the creation of a new indebtedness.

Description of Proposal

The proposal modifies the debt-financed property provisions by excluding from the definition of acquisition indebtedness any indebtedness incurred by a small business investment company licensed under the Small Business Investment Act of 1958 that is evidenced by a debenture (1) issued by such company under section 303(a) of said Act or (2) held or guaranteed by the Small Business Administration.

Effective Date

The proposal applies to debt incurred by a small business investment company after December 31, 2002, with respect to property it acquires after such date.

⁸ Special rules apply in the case of an exempt organization that owns a partnership interest in a partnership that holds debt-financed income-producing property. An exempt organization’s share of partnership income that is derived from such debt-financed property generally is taxed as debt-financed income unless an exception provides otherwise.

B. Provisions to Simplify Small Business Taxation

1. Disclosure of tax information to facilitate combined employment tax reporting (STAWRS)

Present Law

Present law prohibits disclosure of tax returns and return information, except to the extent specifically authorized by the Code (sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding \$5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431). No tax information may be furnished by the IRS to another agency unless the other agency establishes procedures satisfactory to the IRS for safeguarding the tax information it receives (sec. 6103(p)).

The Taxpayer Relief Act of 1997 authorized a demonstration project to assess the feasibility and desirability of expanding combined reporting. The demonstration project was: (1) limited to the State of Montana, (2) limited to employment taxes, (3) limited to taxpayer identity (name, address, taxpayer identifying number) and the signature of the taxpayer, and (4) limited to a period of five years. Authority for the demonstration project expired on August 5, 2002.

To implement that demonstration project, the Taxpayer Relief Act of 1997 amended the Code to authorize the IRS to disclose the name, address, taxpayer identifying number, and signature of the taxpayer, which is common to both the State and Federal portions of the combined form (sec. 6103(d)(5)). The IRS is permitted to disclose these common data items to the State and not have them subject to the redisclosure restrictions, safeguards, or criminal penalty provisions.⁹ Essentially, the State is allowed to use this information as if the State directly received this information from the taxpayer.

Description of Proposal

The provision expands the disclosure authority of the IRS to permit disclosures to any State agency, body, or commission for purposes of carrying out a combined Federal and State employment tax reporting program. The items authorized for disclosure continue to be limited to the name, address, taxpayer identification number, and signature of the taxpayer. The statutory redisclosure restrictions, safeguards, and criminal penalty provisions do not apply to disclosures or inspections made pursuant to this authority.

Effective Date

The proposal is effective after December 31, 2002.

⁹ Section 6103(d)(5). The following restrictions and requirements do not apply: (1) the prohibition on disclosure of returns or return information by State officers and employees (sec. 6103(a)(2)); (2) the Federal penalties for unauthorized disclosure and inspection of returns and return information (secs. 7213 and 7213A); and (3) the requirement that the State establish safeguards regarding the information obtained from the IRS (sec. 6103(p)(4)).

2. Increased deduction for business meals while operating under Department of Transportation hours of service limitations

Present Law

Ordinary and necessary business expenses, as well as expenses incurred for the production of income, are generally deductible, subject to a number of restrictions and limitations. Generally, the amount allowable as a deduction for food and beverages is limited to 50 percent of the otherwise deductible amount. Exceptions to this 50 percent rule are provided for food and beverages provided to crew members of certain vessels and offshore oil or gas platforms or drilling rigs.

The deductible percentage of the cost of food and beverages consumed while away from home by an individual during, or incident to, a period of duty subject to the hours of service limitations of the Department of Transportation is scheduled to gradually increase to 80 percent.

Individuals subject to the hours of service limitations of the Department of Transportation include:

- (1) certain air transportation employees such as pilots, crew, dispatchers, mechanics, and control tower operators pursuant to Federal Aviation Administration regulations,
- (2) interstate truck operators and interstate bus drivers pursuant to Department of Transportation regulations,
- (3) certain railroad employees such as engineers, conductors, train crews, dispatchers and control operations personnel pursuant to Federal Railroad Administration regulations, and
- (4) certain merchant mariners pursuant to Coast Guard regulations.

The increase in the deductible percentage is phased in according to the following schedule:

<u>Taxable years beginning in:</u>	<u>Deductible percentage:</u>
1998 - 1999	55 percent
2000 - 2001	60 percent
2002 - 2003	65 percent
2004 - 2005	70 percent
2006 - 2007	75 percent
2008 and thereafter.....	80 percent

Description of Proposal

The proposal would accelerate the increase in the deduction for business meals while operating under Department of Transportation hours of service limitations so that it becomes 80 percent in 2003 and thereafter.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2002.

C. Provisions Relating to Tax Relief for Farmers, Ranchers and Fishermen

1. Farm, Fish and Ranch Risk Management accounts

Present Law

There is no provision in present law allowing the elective deferral of farm or fishing income.

Description of Proposal

The proposal allows taxpayers engaged in an eligible business to establish Farm, Fish and Ranch Risk Management (FFARRM) accounts. An eligible business is any trade or business of farming in which the taxpayer actively participates, including the operation of a nursery or sod farm or the raising or harvesting of crop-bearing or ornamental trees.¹⁰ An eligible business also includes the trade or business of commercial fishing in which the taxpayer actively participates. The term “commercial fishing” has the meaning given such term by section (3) of the Magnuson-Stevens Fishery Conservation and Management Act (16 U.S.C. 1802) and includes the trade or business of catching, taking or harvesting fish that are intended to enter commerce through sale, barter or trade.

Contributions to a FFARRM account are deductible and are limited to 20 percent of the taxable income that is attributable to the eligible business. For purposes of this 20-percent limitation, taxable income is determined without regard to the FFARRM rules. The deduction is taken into account in determining adjusted gross income and reduces income attributable to the eligible business for all income tax purposes other than the determination of the 20 percent of eligible income limitation on contributions to a FFARRM account. Under the proposal, contributions made on or before the due date (without regard to extensions) of the taxpayer’s return for a taxable year are deemed made on the last day of such year.

A FFARRM account is taxed as a grantor trust and earnings are required to be distributed currently. Thus, any income earned in the FFARRM account is taxed currently to the farmer or fisherman who established the account (but is not taken into account for purposes of the 20-percent limit on contributions).

Contributions to a FFARRM account do not reduce earnings from self-employment. Generally, distributions are not included in self-employment income.

Amounts may remain on deposit in a FFARRM account for up to five years. Any amount that has not been distributed by the close of the fourth year following the year of deposit is deemed distributed and includible in the gross income of the account owner. Distributions for the year are considered first made from the earnings that are required to be distributed. Additional amounts distributed for the year are considered to be made from the oldest deposits.

¹⁰ An evergreen tree that is more than 6 years old when severed from the roots (and thus eligible for capital gains treatment on cutting) is not considered an ornamental tree for this purpose.

Distributions from a FFARRM account may not be used to purchase, lease, or finance any new fishing vessel, add capacity to any fishery, or otherwise contribute to the overcapitalization of any fishery. The Secretary of Commerce shall implement regulations enforcing this restriction.

A taxpayer who has ceased to engage in an eligible business may not maintain a FFARRM account. If the taxpayer does not engage in an eligible business during two consecutive taxable years, the balance in the FFARRM account is deemed distributed to the taxpayer on the last day of such two-year period.

If the taxpayer who established the FFARRM account dies, and the taxpayer's surviving spouse acquires the taxpayer's interest in the FFARRM account by reason of being designated as the beneficiary of the account at the death of the taxpayer, the surviving spouse would "step into the shoes" of the deceased taxpayer with respect to the FFARRM account. In other cases, the account would cease to be a FFARRM account on the date of the taxpayer's death and the balance in the account would generally be deemed distributed to the taxpayer on the date of death.

A FFARRM account is a trust that is created or organized in the United States for the exclusive benefit of the taxpayer who establishes it. The trustee must be a bank or other person who demonstrates to the satisfaction of the Secretary that it will administer the trust in a manner consistent with the requirements of the section. At all times, the assets of the trust must consist entirely of cash and obligations which have adequate stated interest (as defined in section 1274(c)(2)) and which pay such adequate interest not less often than annually. The trust must distribute all income currently, and its assets may not be commingled except in a common trust fund or common investment fund. Additional protections, including rules preventing the trust from engaging in prohibited transactions or from being pledged as security for a loan, are provided.

Penalties would apply in the case of excess contributions and failures to make required distributions.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2002.

2. Exclusion of rental income from self-employment tax

Present Law

Generally, tax under the Self-Employment Contributions Act (SECA) is imposed on the self-employment income of an individual.¹¹ SECA tax has two components. Under the old-age, survivors, and disability insurance component, the rate of tax is 12.40 percent on self-employment income up to the social security wage base (\$84,900 for 2002). Under the

¹¹ Section 1401.

hospital insurance component, the rate is 2.90 percent of all self-employment income (without regard to the social security wage base).

Self-employment income subject to the SECA tax is determined as the net earnings from self-employment. This means the gross income (including the individual's net distributive share of partnership income) derived by an individual from any trade or business carried on by the individual, less the deductions attributable to the trade or business that are allowed under the SECA tax rules. An exclusion from net earnings from self-employment is allowed for certain real estate rentals. Under this present-law rule, net earnings from self-employment for an owner or tenant of land do not include income from the rental of real estate and from personal property leased with the real estate unless: (A) the rental income is received under an arrangement between the owner or tenant of the land and another individual that provides: (1) such other individual produces agricultural or horticultural commodities on such land; and (2) there is material participation by the owner or tenant with respect to any such agricultural or horticultural commodities; and (B) there is material participation by the owner or tenant with respect to any such agricultural or horticultural commodities. Other rules apply to rental payments received by an individual in the course of the individual's trade or business as a real estate dealer.

Description of Proposal

The proposal provides that net earnings from self-employment for an owner or tenant of land do not include income from the rental of real estate except under certain lease agreements (rather than arrangements) between the owner or tenant of land and another individual. Under this proposal, an owner or tenant of land has self-employment income only where (A) the rental income is received under a written lease agreement between the owner or tenant of land and another individual which provides: (1) such other individual shall produce agricultural or horticultural commodities on such land; and (2) there shall be material participation by the owner or tenant in the production or management of the production of such agricultural or horticultural commodities; and (B) there is material participation by the owner or tenant with respect to any such agricultural or horticultural commodities.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2002.

3. Exclusion of conservation reserve program payments from self-employment tax

Present Law

Generally, tax under the Self-Employment Contributions Act (SECA) is imposed on the self-employment income of an individual.¹² SECA tax has two components. Under the old-age, survivors, and disability insurance component, the rate of tax is 12.40 percent on self-employment income up to the social security wage base (\$84,900 for 2002). Under the hospital insurance component, the rate is 2.90 percent of all self-employment income (without regard to the social security wage base).

¹² Section 1401.

Self-employment income subject to the SECA tax is determined as the net earnings from self-employment. This means the gross income derived by an individual from any trade or business carried on by the individual, less the deductions attributable to the trade or business that are allowed under the SECA tax rules. A recent court decision found that payments made under the Department of Agriculture's conservation reserve program are includible in an individual's self-employment income for purposes of SECA tax.¹³

Description of Proposal

The proposal provides for purposes of the SECA tax that net earnings from self-employment do not include conservation reserve program payments.

Effective Date

The proposal is effective for payments made after December 31, 2002.

4. Exemption of agricultural bonds from private activity bond volume limits

Present Law

Interest on bonds issued by States and local governments is excluded from income if the proceeds of the bonds are used to finance activities conducted and paid for by the governmental units (sec. 103). Interest on bonds issued by these governmental units to finance activities carried out and paid for by private persons ("private activity bonds") is taxable unless the activities are specified in the Internal Revenue Code. Private activity bonds on which interest may be tax-exempt include bonds issued to finance loans to first-time farmers for the acquisition of land and certain equipment (so-called "aggie bonds").

The volume of tax-exempt private activity bonds that States and local governments may issue in each calendar year (including aggie bonds) is limited by State-wide volume limits. For 2002, the volume limits will be the greater of: (1) \$75 per resident of the State; or (2) \$225 million. The volume limits do not apply to private activity bonds to finance airports, docks and wharves, certain governmentally owned, and privately operated solid waste disposal facilities, certain high speed rail facilities, and to certain types of private activity tax-exempt bonds that are subject to other limits on their volume (qualified veterans' mortgage bonds and certain empowerment zone and enterprise community bonds).

Description of Proposal

The proposal exempts aggie bonds from the private activity bond volume limits.

Effective Date

The proposal is effective for bonds issued after December 31, 2002.

¹³ *Wuebker v. Commissioner*, 205 F.3d 897 (6th Cir. 2000), *rev'g* 110 T.C. 431 (1998).

5. Coordinate farmers and fisherman income averaging and the alternative minimum tax

Present Law

An individual taxpayer engaged in a farming business as defined by section 263A(e)(4) may elect to compute his or her current year tax liability by averaging, over the prior three-year period, all or portion of his or her taxable income from the trade or business of farming. The averaging election is not coordinated with the alternative minimum tax. Thus, some farmers may become subject to the alternative minimum tax solely as a result of the averaging election.

Description of Proposal

The proposal extends to individuals engaged in the trade or business of fishing the election that is available to individual farmers to use income averaging.

The proposal also coordinates farmers and fishermen income averaging with the alternative minimum tax. Under the proposal, a farmer would owe alternative minimum tax only to the extent he or she would owe alternative minimum tax had averaging not been elected. This result is achieved by excluding the impact of the election to average farm income from the calculation of both regular tax and tentative minimum tax, solely for the purpose of determining alternative minimum tax.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2002.

6. Modify cooperative marketing rules to include value added processing involving animals

Present Law

Under present law, cooperatives generally are treated similarly to pass-through entities in that the cooperative is not subject to corporate income tax to the extent the cooperative timely pays patronage dividends. Farmers' cooperatives are tax-exempt and include cooperatives of farmers, fruit growers, and like organizations that are organized and operated on a cooperative basis for the purpose of marketing the products of members or other producers and remitting the proceeds of sales, less necessary marketing expenses, on the basis of either the quantity or the value of products furnished by them (sec. 521). Farmers' cooperatives may claim a limited amount of additional deductions for dividends on capital stock and patronage-based distributions of nonpatronage income.

In determining whether a cooperative qualifies as a tax-exempt farmers' cooperative, the IRS has apparently taken the position that a cooperative is not marketing certain products of members or other producers if the cooperative adds value through the use of animals (e.g., farmers sell corn to a cooperative which is fed to chickens that produce eggs sold by the cooperative).

Description of Proposal

The proposal provides that marketing products of members or other producers includes feeding products of members or other producers to cattle, hogs, fish, chickens, or other animals and selling the resulting animals or animal products.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2002.

7. Extend declaratory judgment procedures to farmers' cooperative organizations

Present Law

In limited circumstances, the Code provide declaratory judgment procedures, which generally permit a taxpayer to seek judicial review of an IRS determination prior to the issuance of a notice of deficiency and prior to payment of tax. Examples of declaratory judgment procedures that are available include disputes involving the initial or continuing classification of a tax-exempt organization described in section 501(c)(3), a private foundation described in section 509(a), or a private operating foundation described in section 4942(j)(3), the qualification of retirement plans, the value of gifts, the status of certain governmental obligations, or eligibility of an estate to pay tax in installments under section 6166.¹⁴ In such cases, taxpayers may challenge adverse determinations by commencing a declaratory judgment action. For example, where the IRS denies an organization's application for recognition of exemption under section 501(c)(3) or fails to act on such application, or where the IRS informs a section 501(c)(3) organization that it is considering revoking or adversely modifying its tax-exempt status, present law authorizes the organization to seek a declaratory judgment regarding its tax exempt status.

Declaratory judgment procedures are not available under present law to a cooperative with respect to an IRS determination regarding its status as a farmers' cooperative under section 521.

Description of Proposal

The proposal extends the declaratory judgment procedures to cooperatives. Such a case may be commenced in the U.S. Tax Court, a U.S. district court, or the U.S. Court of Federal Claims, and such court would have jurisdiction to determine a cooperative's initial or continuing qualification as a farmers' cooperative described in section 521.

¹⁴ For disputes involving the initial or continuing qualification of an organization described in sections 501(c)(3), 509(a), or 4942(j)(3), declaratory judgment actions may be brought in the U.S. Tax Court, a U.S. district court, or the U.S. Court of Federal Claims. For all other Federal tax declaratory judgment actions, proceedings may be brought only in the U.S. Tax Court.

Effective Date

The proposal is effective for pleadings filed after the date of enactment with respect to determinations (or requests for determinations) made after January 1, 2002.

8. Payment of dividends on stock of cooperatives without reducing patronage dividends

Present Law

Under present law, cooperatives generally are treated similarly to pass-through entities in that the cooperative is not subject to corporate income tax to the extent the cooperative timely pays patronage dividends. In general, patronage dividends are comprised of amounts that are paid to patrons (1) on the basis of the quantity or value of business done with or for patrons, (2) under a valid enforceable written obligation to the patron that was in existence before the cooperative received such amounts, and (3) which are determined by reference to the net earnings of the cooperative from business done with or for patrons.

Treasury Regulations provide that net earnings are reduced by dividends paid on capital stock or other proprietary capital interests. The effect of this rule is to reduce the amount of earnings that a cooperative can treat as patronage income and, thus, the amount that the cooperative can deduct as patronage dividends.

Description of Proposal

The proposal provides a special rule for dividends on capital stock of a cooperative. To the extent provided in organizational documents of the cooperative, dividends on capital stock do not reduce patronage income.

Effective Date

The proposal is effective for distributions in taxable years beginning after December 31, 2002.

9. Special rules for livestock sold on account of weather-related conditions

Present Law

Generally, a taxpayer recognizes gain to the extent the sales price (and any other consideration received) exceeds the seller's basis in the property. The recognized gain is subject to current income tax unless the gain is deferred or not recognized under a special tax provision.

Under section 1033, gain realized by a taxpayer from an involuntary conversion of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property within the applicable period. The taxpayer's basis in the replacement property generally is the same as the taxpayer's basis in the converted property, decreased by the amount of any money or loss recognized on the conversion, and increased by the amount of any gain recognized on the conversion.

The applicable period for the taxpayer to replace the converted property begins with the date of the disposition of the converted property (or if earlier, the earliest date of the threat or imminence of requisition or condemnation of the converted property) and ends two years after the close of the first taxable year in which any part of the gain upon conversion is realized (the “replacement period”). Special rules extend the replacement period for certain real property and principle residences damaged by a Presidentially declared disaster to three years and four years, respectively, after the close of the first taxable year in which gain is realized.

Section 1033(e) provides that the sale of livestock (other than poultry) that is held for draft, breeding, or dairy purposes in excess of the number of livestock that would have been sold but for drought, flood, or other weather-related conditions is treated as an involuntary conversion. Consequently, gain from the sale of such livestock could be deferred by reinvesting the proceeds of the sale in similar property within a two-year period.

In general, cash-method taxpayers report income in the year it is actually or constructively received. However, section 451(e) provides that a cash-method taxpayer whose principal trade or business is farming who is forced to sell livestock due to drought, flood, or other weather-related conditions may elect to include income from the sale of the livestock in the taxable year following the taxable year of the sale. This elective deferral of income is available only if the taxpayer establishes that, under the taxpayer's usual business practices, the sale would not have occurred but for drought, flood, or weather-related conditions that resulted in the area being designated as eligible for Federal assistance. This exception is generally intended to put taxpayers who receive an unusually high amount of income in one year in the position they would have been in absent the weather-related condition.

Description of Proposal

The proposal extends the applicable period for a taxpayer to replace livestock sold on account of drought, flood, or other weather-related conditions from two years to four years after the close of the first taxable year in which any part of the gain on conversion is realized. The extension is only available if the taxpayer establishes that, under the taxpayer's usual business practices, the sale would not have occurred but for drought, flood, or weather-related conditions that resulted in the area being designated as eligible for Federal assistance. In addition, the Secretary of the Treasury is granted authority to further extend the replacement period on a regional basis should the weather-related conditions continue longer than 3 years. Also, for property eligible for the proposal's extended replacement period, the proposal provides that the taxpayer can make an election under section 451(e) until the period for reinvestment of such property under section 1033 expires.

Effective Date

The proposal is effective for taxable years ending after date of enactment.

10. Farmer optional method for computing net earnings from self-employment

Present Law

In general

Generally, tax under the Self-Employment Contributions Act (SECA) is imposed on the self-employment income of an individual.¹⁵ SECA tax has two components. Under the old-age, survivors, and disability insurance component, the rate of tax is 12.40 percent on self-employment income up to the social security wage base (\$84,900 for 2002). Under the hospital insurance component, the rate is 2.90 percent of all self-employment income (without regard to the social security wage base).

Self-employment income subject to the SECA tax is determined as the net earnings from self-employment. An individual may use one of three methods to calculate net earnings from self-employment. Under the generally applicable rule, net earnings from self-employment means gross income (including the individual's net distributive share of partnership income) derived by an individual from any trade or business carried on by the individual, less the deductions attributable to the trade or business that are allowed under the SECA tax rules. Alternatively, an individual may elect to use one of two optional methods for calculating net earnings from self-employment.¹⁶ These methods¹⁷ are the: (1) the farmer optional method; and (2) the nonfarm optional method. The farmer optional method allows individuals to pay SECA taxes (and secure Social Security benefit coverage) when they have low net profits or a loss from farming. The nonfarm optional method is similar to the farmer optional method.

Farmer optional method

If an individual is engaged in a farming business, either as a sole proprietor or as a partner, the individual may elect to use the farmer optional method in one of two instances. The first instance is an individual engaged in a farming business who has gross farm income of \$2,400 or less for the taxable year. In this instance, the individual may elect to report two-thirds of gross farm income as their net earnings from self-employment. In the second instance, an individual engaged in a farming business may elect the farmer optional method even though gross farm income exceeds \$2,400 for the taxable year but only if the net farm profits is less than \$1,733 for the taxable year. In this second instance the individual may elect to report \$1,600 as their net earnings farm self-employment for the taxable year. In all other instances (i.e., more than \$2,400 of gross farm income and net farm profits of at least \$1,733) a person engaged in a

¹⁵ Section 1401.

¹⁶ An individual must use actual self-employment income for purposes of computing income tax liability regardless of the method used in calculating SECA tax liability.

¹⁷ An individual may elect to use both optional methods but net earnings from farming and nonfarming activities must be separately calculated. Also, such an individual cannot report more than \$1,600 of combined net earnings from self-employment each taxable year.

farming business must compute net earnings from self-employment under the generally applicable rule.

Nonfarm optional method

The nonfarm optional method is available only to individuals that have been self-employed for at least two of the three years before the year in which they seek to elect the nonfarm optional method and who meet certain other requirements. Specifically, an individual may elect the nonfarm optional method, if the individual's: (1) net nonfarm profits for the taxable year are less than \$1,733; and (2) net nonfarm profits for the taxable year are less than 72.189% of their gross nonfarm income. An individual may elect to use the nonfarm optional method for no more than five years in the course of the individual's lifetime. If a qualified individual engaged in a nonfarming business who elects the nonfarm optional method has gross nonfarm income of \$2,400 or less for the taxable year, then the individual may elect to report two-thirds of gross nonfarm income as their net earnings from self-employment. If the electing individual engaged in a nonfarming business has gross nonfarm income of at least \$2,400 for the taxable year, then the individual may elect to report \$1,600 as their net earnings from self-employment for the taxable year. In all other instances a person engaged in a nonfarming business must compute net earnings from self-employment under the generally applicable rule.

Description of Proposal

The proposal simplifies the calculation of the optional method of self-employment income for both farmers and nonfarmers. This simplification is achieved by combining the farmer optional method and the nonfarm optional method. Also, the new combined optional method allows an electing individual to be eligible for up to four quarters of Social Security coverage in each taxable year. This is achieved by coordinating the optional method election amounts to the minimum amounts of income necessary for four quarters of Social Security coverage. Unlike present law, the amounts under the combined optional method will be adjusted automatically when the minimum amounts necessary for four quarters of Social Security coverage is changed.

Under the proposal, if an individual has: (1) gross income for the taxable year from a trade or business that does not exceed one and one-half times the amount of net income required to qualify for four quarters of Social Security coverage in the taxable year; and (2) net earnings for the taxable year from such trade or business which are less than two-thirds of the individual's gross income for the taxable year, such individual may elect to report two-thirds of gross income as net earnings from self-employment for the taxable year. Similar treatment is provided for a member of a partnership carrying on a trade or business.

Also under the proposal, if an individual has: (1) gross income for the taxable year from a trade or business in excess of one and one-half times the amount of net income required to qualify for four quarters of Social Security coverage in the taxable year, and (2) net earnings for the taxable year from such trade or business are less than the amount of net income required to qualify for four quarters of Social Security coverage in the taxable year; such individual may elect to report the amount of net income required to qualify for four quarters of coverage in the

taxable year as net earnings from self-employment for the taxable year. Similar treatment is provided for a member of a partnership carrying on a trade or business.

In the case of a cash method trade or business, gross income is defined as the gross receipts from such trade or business less the cost or other basis of property sold in carrying out such trade or business with certain adjustments. In the case of an accrual method trade or business, gross income is defined as the gross income from the trade or business with certain adjustments. In each case, these adjustments are similar to those made under present-law. If an individual (including a member of a partnership) derives gross income from more than one trade or business then such gross income (including the individual's distributive share of the gross income of any partnership) is treated as derived from a single trade or business. Under the proposal, the election is allowed for a taxable year only if elected on the first tax return filed for such taxable year. There is no limit on the number of years that an individual may elect this method during such individual's lifetime.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2002.

11. Capital gains treatment to apply to outright sales of timber by landowner

Present Law

Under present law, a taxpayer disposing of timber held for more than one year is eligible for capital gains treatment in three situations. First, if the taxpayer sells or exchanges timber that is a capital asset (sec. 1221) or property used in the trade or business (sec. 1231), the gain generally is long-term capital gain; however, if the timber is held for sale to customers in the taxpayer's business, the gain will be ordinary income. Second, if the taxpayer disposes of the timber with a retained economic interest, the gain is eligible for capital gain treatment (sec. 631(b)). Third, if the taxpayer cuts standing timber, the taxpayer may elect to treat the cutting as a sale or exchange eligible for capital gains treatment (sec. 631(a)).

Description of Proposal

Under the proposal, in the case of a sale of timber by the owner of the land from which the timber is cut, the requirement that a taxpayer retain an economic interest in the timber in order to treat gains as capital gain under section 631(b) does not apply. Outright sales of timber by the landowner will qualify for capital gains treatment in the same manner as sales with a retained economic interest qualify under present law, except that the usual tax rules relating to the timing of the income from the sale of the timber will apply (rather than the special rule of section 631(b) treating the disposal as occurring on the date the timber is cut).

Effective Date

The proposal applies to sales of timber after December 31, 2002.

12. Expensing of certain reforestation expenditures

Present Law

Amortization of reforestation costs (sec. 194)

A taxpayer may elect to amortize up to \$10,000 (\$5,000 in the case of a separate return by a married individual) of qualifying reforestation expenditures incurred during the taxable year with respect to qualifying timber property. Amortization is taken over 84 months (seven years) and is subject to a mandatory half-year convention. In the case of an individual, the amortization deduction is allowed in determining adjusted gross income (i.e., an “above-the-line deduction”) rather than as an itemized deduction.

Qualifying reforestation expenditures are the direct costs a taxpayer incurs in connection with the forestation or reforestation of a site by planting or seeding, and include costs for the preparation of the site, the cost of the seed or seedlings, and the cost of the labor and tools (including depreciation of long lived assets such as tractors and other machines) used in the reforestation activity. Qualifying reforestation expenditures do not include expenditures that would otherwise be deductible and do not include costs for which the taxpayer has been reimbursed under a governmental cost sharing program, unless the amount of the reimbursement is also included in the taxpayer’s gross income.

The amount amortized is reduced by one half of the amount of reforestation credit claimed under section 48(b) (see below). Reforestation amortization is subject to recapture as ordinary income on sale of qualifying timber property within 10 years of the year in which the qualifying reforestation expenditures were incurred.

Reforestation tax credit (sec. 48(b))

A tax credit is allowed equal to 10 percent of the reforestation expenditures incurred during the year that are properly elected to be amortized. An amount allowed as a credit is subject to recapture if the qualifying timber property to which the expenditure relates is disposed of within five years.

Description of Proposal

The proposal permits taxpayers to elect to deduct (*i.e.*, expense) up to \$15,000 (\$7,500 in the case of a separate return by a married individual) of qualifying reforestation expenditures incurred during the taxable year with respect to qualifying timber property.

The proposal replaces both the amortization and credit provisions of present law.

Effective Date

The proposal is effective for expenditures paid or incurred in taxable years beginning after December 31, 2002.

D. Provisions Relating to S Corporation Reform and Simplification

1. Maximum number of shareholders of an S corporation

Present Law

The taxable income or loss of an S corporation is taken into account by the corporation's shareholders, rather than by the entity, whether or not such income is distributed. A small business corporation may elect to be treated as an S corporation. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which does not have (1) more than 75-shareholders; (2) as a shareholder, a person (other than certain trusts, estates, charities, and qualified retirement plans) who is not an individual; (3) a nonresident alien as a shareholder; and (4) more than one class of stock. For purposes of the 75-shareholder limitation, a husband and wife are treated as one shareholder. An "ineligible corporation" means any corporation that is a member of an affiliated group, certain financial institutions that use the reserve method of accounting for bad debts, certain insurance companies, a section 936 corporation, or a DISC or former DISC.

Description of Proposal

The proposal provides that all family members owning stock can elect to be treated as one shareholder. A family is defined as the lineal descendants of a common ancestor (and their spouses). The common ancestor cannot be more than three generations removed from the youngest generation of shareholder at the time the S election is made (or the effective date of this provision, if later). The election is made available to only one family per corporation, must be made with the consent of all shareholders of the corporation and remains in effect until terminated.

The proposal increases the maximum number of eligible shareholders from 75 to 100.

Effective Date

The proposal relating to families applies to taxable years beginning after December 31, 2003.

The proposal relating to the number of shareholders applies to taxable years beginning after December 31, 2002.

2. Termination of election and additions to tax due to passive investment income

Present Law

An S corporation is subject to corporate-level tax, at the highest marginal corporate tax rate, on its net passive income if the corporation has (1) subchapter C earnings and profits at the close of the taxable year and (2) gross receipts more than 25 percent of which are passive investment income.

In addition, an S corporation election is terminated whenever the corporation has subchapter C earnings and profits at the close of three consecutive taxable years and has gross receipts for each of such years more than 25 percent of which are passive investment income.

For these purposes, "passive investment income" generally means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (to the extent of gains). "Passive investment income" generally does not include interest on accounts receivable, gross receipts that are derived directly from the active and regular conduct of a lending or finance business, gross receipts from certain liquidations, or gain or loss from any section 1256 contract (or related property) of an options or commodity dealer. "Net passive income" is defined as passive investment income reduced by the allowable deductions that are directly connected with the production of the income.

Description of Proposal

The proposal increases the 25-percent threshold to 60 percent.

The proposal repeals capital gain as a category of passive income.

Effective Date

The proposal applies to taxable years beginning after December 31, 2002.

3. Treatment of S corporation shareholders

(a) In general

Present Law

In general, each S corporation shareholder takes into account its pro rata share of the S corporation income and loss for the taxable year.

Description of Proposal

The proposal makes the following changes in the treatment of S corporation shareholders:

Under the proposal, if a shareholder's stock in an S corporation is transferred incident to a divorce decree, the pro rata share of any suspended corporate loss is transferred to the transferee spouse.

Under the proposal, the beneficiary of a qualified subchapter S trust is allowed the suspended losses under the at-risk rules and the passive loss rules when the trust disposes of the stock.

Effective Date

The provisions apply to taxable years beginning after December 31, 2002.

(b) Electing small business trusts

Present Law

Under present law, an electing small business trust (“ESBT”) may be an S corporation shareholder. In general, the beneficiaries of an ESBT must be individuals and others taxpayers that may own stock in an S corporation directly. Each potential current beneficiary of the trust is counted as a shareholder in determining whether or not the corporation meets the requirement that an S corporation have no more than 75 shareholders.

The portion of the trust consisting of S corporation stock is treated as a separate trust. The trust is taxed at the maximum trust tax rate (which is the same as the maximum individual tax rate) on the items of income, deduction, gain, or loss passing through from the S corporation. The remaining portion of the trust is treated as a separate trust taxed under the normal rules relating to the taxation of trusts and beneficiaries. In computing the amount of the distribution deduction for the trust, no subchapter S items are taken into account.

Description of Proposal

Under the proposal, unexercised powers of appointment are disregarded in determining the beneficiaries of an electing small business trust.

Under the proposal, the treatment of distributions from an electing small business trust is clarified by treating distributions from each portion (i.e., the portion attributable to the S corporation stock and the remaining portion) of the trust as separate distributions.

Effective Date

The proposals apply to taxable years beginning after December 31, 2002.

4. Provisions relating to banks

(a) IRAs holding bank stock

Present Law

An individual retirement arrangement (“IRA”) may not hold stock in an S corporation.

Description of Proposal

The proposal allows an IRA holding bank stock to sell the stock to the beneficiary of the IRA without the imposition of a prohibited transaction tax, in order to allow the corporation to be eligible to elect to be an S corporation.

Effective Date

The proposal applies to stock held by an IRA on the date of enactment.

(b) Exclusion of investment securities income from passive income test for bank S corporations

Present Law

An S corporation is subject to corporate-level tax, at the highest marginal corporate tax rate, on its net passive income if the corporation has (1) subchapter C earnings and profits at the close of the taxable year and (2) gross receipts more than 25 percent of which are passive investment income.

In addition, an S corporation election is terminated whenever the corporation has subchapter C earnings and profits at the close of three consecutive taxable years and has gross receipts for each of such years more than 25 percent of which are passive investment income.

For these purposes, "passive investment income" generally means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (to the extent of gains). "Passive investment income" generally does not include interest on accounts receivable, gross receipts that are derived directly from the active and regular conduct of a lending or finance business, gross receipts from certain liquidations, or gain or loss from any section 1256 contract (or related property) of an options or commodity dealer. "Net passive income" is defined as passive investment income reduced by the allowable deductions that are directly connected with the production of the income.

Description of Proposal

The proposal provides that, in the case of a bank or bank holding company, passive income does not include interest and does not include dividends on assets required to be held by the bank or bank holding company.

Effective Date

The proposal applies to taxable years beginning after December 31, 2002.

(c) Treatment of qualifying director shares

Present Law

A small business corporation may elect to be treated as an S corporation. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which does not have (1) more than 75 shareholders; (2) as a shareholder, a person (other than certain trusts, estates, charities, or qualified retirement plans) who is not an individual; (3) a nonresident alien as a shareholder; and (4) more than one class of stock.

Description of Proposal

Under the proposal, shares held by reason of being a bank director that are subject to an agreement pursuant to which the holder is required to dispose of the shares upon termination of

the holder's status as a director at the same price the individual acquired the shares are not treated as a second class of stock. Distributions are treated like interest payments.

Effective Date

The proposal applies to taxable years beginning after December 31, 2002.

5. Qualified subchapter S subsidiaries

(a) Relief from inadvertently invalid qualified subchapter S subsidiaries and elections and terminations

Present Law

Under present law, inadvertent subchapter S elections and terminations may be waived.

Description of Proposal

The proposal allows inadvertent qualified subchapter S subsidiary elections and terminations to be waived by the IRS.

Effective Date

The proposal applies to taxable years beginning after December 31, 2002.

(b) Information returns for qualified subchapter S subsidiaries

Present Law

Under present law, a wholly owned subsidiary of an S corporation may elect to be treated as not a separate corporation. The assets, liabilities, and items of income, deduction, and credit of the subsidiary are treated as assets, liabilities, and items of the parent S corporation.

Description of Proposal

The proposal provides authority to the Secretary of the Treasury to provide guidance regarding information returns of subchapter S subsidiaries.

Effective Date

The proposal applies to taxable years beginning after December 31, 2002.

E. Provisions to Promote Economic Development and Rural Investment

1. Accelerated depreciation for investment in high out-migration counties

Present Law

In general

Overview

Present law permits taxpayers to recover the costs of investment through annual deductions for depreciation or amortization or, in some circumstances, through expensing of the cost of acquisition in the year of acquisition. These rules apply generally regardless of the geographic location of the taxpayer or the property. However, in certain circumstances, the Code modifies these rules depending upon the geographic location of the property.

Cost recovery through depreciation deductions

Under present law, a taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the Modified Accelerated Cost Recovery System (MACRS) of section 168, which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.

Present law allows an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified property. The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service. The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction.

In order for property to qualify for the additional first-year depreciation deduction, it must meet the following requirements. First, the property must be property to which the rules of MACRS apply with (1) an applicable recovery period of 20 years or less, (2) water utility property (as defined in section 168(e)(5)), (3) computer software (other than computer software covered by section 197), or (4) certain qualified leasehold improvement property. In addition, the original use of the qualifying property must commence with the taxpayer on or after September 11, 2001. In general, the taxpayer must purchase the property after September 10, 2001 and before September 11, 2004. Finally, the property must be placed in service before January 1, 2005.

Cost recovery through expensing

Present law provides that, in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to \$24,000 of the cost of qualifying property

placed in service for the taxable year (sec. 179). This amount is increased to \$25,000 of the cost of qualified property placed in service for taxable years beginning in 2003 and thereafter. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The \$24,000 (\$25,000 for taxable years beginning in 2003 and thereafter) amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000.

Accelerated depreciation of property on Indian reservations

A special depreciation recovery period is available to qualified Indian reservation property.¹⁸ In general, qualified Indian reservation property is property used predominantly in the active conduct of a trade or business within an Indian reservation, which is not used outside the reservation on a regular basis and was not acquired from a related person. Property used to conduct or house certain gaming activities is not qualified Indian reservation property.

The applicable recovery period for qualified Indian reservation property is as follows:

In the case of:	The applicable recovery period is:
3 year property	2 years
5 year property	3 years
7 year property	4 years
10 year property	6 years
15 year property	9 years
20 year property	12 years
Nonresidential real property	22 years

Accelerated depreciation of property on Indian reservations is not available for property placed in service after December 31, 2004.

Additional first-year depreciation deduction for New York Liberty Zone property

Present law allows an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified New York Liberty Zone¹⁹ (“Liberty Zone”) property. The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service. The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.

¹⁸ Section 168(j).

¹⁹ The “New York Liberty Zone” means the area located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan in the City of New York, New York.

In order for property to qualify for the additional first-year depreciation deduction it must meet all of the following requirements. First, the property must be property to which the general rules of MACRS apply with (1) an applicable recovery period of 20 years or less, (2) water utility property (as defined in sec. 168(e)(5)), (3) certain nonresidential real property and residential rental property, or (4) computer software other than computer software covered by section 197. A special rule precludes the additional first year depreciation under this provision for qualified leasehold improvement property and property eligible for the additional first year depreciation under section 168(k). Second, substantially all of the use of such property must be in the Liberty Zone. Third, the original use of the property in the Liberty Zone must commence with the taxpayer on or after September 11, 2001. Finally, the property must be acquired by purchase by the taxpayer (1) after September 10, 2001 and placed in service on or before December 31, 2006. For qualifying nonresidential real property and residential rental property the property must be placed in service on or before December 31, 2009 in lieu of December 31, 2006. Property will not qualify if a binding written contract for the acquisition of such property is in effect before September 11, 2001.

Increased expensing allowances

Additional expensing under section 179 is provided with respect to qualified property used by a business in an empowerment zone (sec. 1397A), used in a renewal community (sec. 1400J), or used in the New York Liberty Zone (sec. 1400L). Such a business may elect to deduct an additional \$35,000 of the cost of qualified zone property placed in service in years beginning in 2002 and thereafter. In addition, the phase-out range is applied by taking into account only 50 percent of the cost of qualified zone property that is section 179 property. Qualified zone property means property to which section 168 applies (or would apply if no sec. 179 deduction were allowed) if such property was (1) acquired by the taxpayer through purchase after the date on which the empowerment zone designation took effect, (2) the original use of the property in an empowerment zone commenced with the taxpayer and (3) substantially all of the use of the property is in an empowerment zone and in the active conduct of a qualified business by the taxpayer in an empowerment zone. For renewal communities, qualified renewal property is qualified zone property if renewal community were substituted for the reference to empowerment zone and the property was acquired by the taxpayer by purchase after December 31, 2001 and before January 1, 2010. In the case of the New York Liberty Zone, qualifying property means section 179 property purchased and placed in service by the taxpayer after September 10, 2001 and before January 1, 2007.

Description of Proposal

The proposal provides a special depreciation recovery period for qualified rural investment property. In general, qualified rural investment property is property used predominantly in the active conduct of a trade or business within a high out-migration county, which is not used outside such county on a regular basis, and was not acquired from a related person. A “high out-migration county” is a county located outside a metropolitan statistical area (as defined by the Office of Management and Budget) that experienced net population loss during the five-year period 1990 through 1994 and also during the five-year period 1995 through 1999. Property used to conduct or house certain gaming activities is not qualified rural investment property.

The applicable recovery period for qualified rural investment property is as follows:

In the case of:	The applicable recovery period is:
3 year property	2 years
5 year property	3 years
7 year property	4 years
10 year property	6 years
15 year property	9 years
20 year property	12 years
Nonresidential real property	22 years

Accelerated depreciation of property in high out-migration counties is not available for property placed in service after December 31, 2004.

Effective Date

The proposal is effective for property placed in service after December 31, 2002.

2. Treatment of expenses of rural letter carriers' vehicles

Present Law

A taxpayer who uses his or her automobile for business purposes may deduct the business portion of the actual operation and maintenance expenses of the vehicle, plus depreciation (subject to the limitations of sec. 280F). Alternatively, the taxpayer may elect to utilize a standard mileage rate in computing the deduction allowable for business use of an automobile that has not been fully depreciated. Under this election, the taxpayer's deduction equals the applicable rate multiplied by the number of miles driven for business purposes and is taken in lieu of deductions for depreciation and actual operation and maintenance expenses.

Rural letter carriers are paid an equipment maintenance allowance (EMA) by the U.S. Postal Service to compensate them for the use of their personal automobiles in delivering the mail. For tax purposes, the rate of reimbursement provided by the U.S. Postal Service to rural letter carriers is considered to be equivalent to their expenses (sec. 162(o)). Accordingly, carriers whose actual expenses are less than the amount reimbursed do not recognize the excess as income and carriers whose actual expenses are more than the amount reimbursed are not allowed to claim an itemized deduction for the costs that exceed their reimbursements.

Description of Proposal

The proposal provides that if the reimbursements that a rural letter carrier receives from the U.S. Postal Service are less than the carrier's otherwise allowable costs, the costs in excess of reimbursements qualify as a miscellaneous itemized deduction subject to the two-percent floor.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2002.

3. Broadband internet access tax credit

Present Law

Present law does not provide a credit for investments in telecommunications infrastructure.

Description of Proposal

The proposal provides a credit of 10 percent of the qualified expenditures incurred by the taxpayer with respect to qualified equipment with which the taxpayer offers “current generation” broadband services to subscribers in rural and underserved areas. In addition, the proposal provides a credit of 20 percent of the qualified expenditures incurred by the taxpayer with respect to qualified equipment with which the taxpayer offers “next generation” broadband services to subscribers in rural areas, underserved areas, and to residential subscribers. Current generation broadband services are defined as the transmission of signals at a rate of at least 1.0 million bits per second to the subscriber and at a rate of at least 128,000 bits per second from the subscriber. Next generation broadband services are defined as the transmission of signals at a rate of at least 22 million bits per second to the subscriber and at a rate of at least 5.0 million bits per second from the subscriber.

Qualified expenditures are those amounts otherwise chargeable to the capital account with respect to the purchase and installation of qualified equipment for which depreciation is allowable under section 168. Qualified expenditures are those that are incurred by the taxpayer after December 31, 2002, and before January 1, 2005. The expenditures are taken into account for purposes of claiming the credit in the first taxable year in which the taxpayer provides broadband service to potential subscribers. In the case of a taxpayer who incurs expenditures for equipment capable of serving both subscribers in qualifying areas and other areas, qualifying expenditures are determined by multiplying otherwise qualifying expenditures by the ratio of the number of potential qualifying subscribers to all potential subscribers the qualifying equipment is capable of serving. For purposes of the current generation broadband credit, residential subscribers residing in a rural or underserved area that is a “saturated market” are not qualified subscribers in determination of the allocation of expenses eligible for the credit. A “saturated market” is any census tract in which a single provider provides current generation broadband service to 85 percent or more of potential residential subscribers.

Qualifying equipment must be capable of providing broadband services at least a majority of the time during periods of maximum demand to each subscriber who is utilizing such services. In the case of a telecommunications carrier, qualifying equipment is only that equipment that extends from the last point of switching to the outside of the building in which the subscriber is located. In the case of a commercial mobile service carrier, qualifying equipment is only that equipment that extends from the customer side of a mobile telephone switching office to a transmission/reception antenna (including the antenna) of the subscriber. In the case of a cable operator or open video system operator, qualifying equipment is only that equipment that extends from the customer side of the headend to the outside of the building in which the subscriber is located. In the case of a satellite carrier or other wireless carrier (other than a telecommunications carrier), qualifying equipment is only that equipment that extends

from a transmission/reception antenna (including the antenna) to a transmission/reception antenna on the outside of the building used by the subscriber. In addition, any packet switching equipment deployed in connection with other qualifying equipment is qualifying equipment, regardless of location, provided that it is the last such equipment in a series as part of transmission of a signal to a subscriber or the first in a series in the transmission of a signal from a subscriber. Multiplexing and demultiplexing equipment is qualifying equipment if located between qualifying packet switching equipment and the subscriber's premises.

A rural area is any census tract that is not within 10 miles of any incorporated or census designated place with a population of more than 25,000 and that is not within a county with a population density of more than 500 people per square mile. An underserved area is any census tract which is located in an empowerment zone, enterprise community, the District of Columbia enterprise zone, renewal community, or any census tract in which the poverty level is greater than or equal to 20 percent or in which the median family income is less than 80 percent of the greater of metropolitan area median family income (if applicable) or statewide median family income. A residential subscriber is any individual who purchases broadband service to be delivered to his or her dwelling.

Effective Date

The proposal is effective for expenditures incurred after December 31, 2002.

4. Broadband provisions relating to housing: modification to the low-income housing credit allocation criteria

Present Law

The low-income housing tax credit (the "LIHC") may be claimed over a 10-year period for the cost of rental housing occupied by tenants having incomes below specified levels. The credit percentage for newly constructed or substantially rehabilitated housing that is not Federally subsidized is adjusted monthly by the Internal Revenue Service so that the 10 annual installments have a present value of 70 percent of the total qualified expenditures. The credit percentage for new substantially rehabilitated housing that is Federally subsidized and for existing housing that is substantially rehabilitated is calculated to have a present value of 30 percent qualified expenditures. The aggregate credit authority provided annually to each State is \$1.75 per resident, except in the case of projects that also receive financing with proceeds of tax-exempt bonds issued subject to the private activity bond volume limit and certain carry-over amounts. The \$1.75 per resident cap is indexed for inflation.

Each State must develop a plan for allocating credits and such plan must include certain allocation criteria including: (1) project location; (2) housing needs characteristics; (3) project characteristics; (4) sponsor characteristics; (5) tenant populations with special needs; (6) public housing waiting lists; (7) tenant populations of individuals with children; and (8) projects intended for eventual tenant ownership. Project characteristics include whether the project includes the use of existing housing as part of a community revitalization plan.

The State allocation plan must give preference to housing projects: (1) that serve the lowest income tenants; (2) that are obligated to serve qualified tenants for the longest periods;

and (3) that are located in certain qualified census tracts, the development of which contributes to a concerted redevelopment plan.

Description of Proposal

The proposal adds another project characteristic under the third criterion for allocation of the low-income housing credit. Specifically, the proposal includes among the project characteristics that the project has infrastructure permitting each residential unit the use of high-speed Internet technology.

Effective Date

The proposal generally is effective for calendar years beginning after December 31, 2002, and buildings placed-in-service after such date in the case of projects that also receive financing with proceeds of tax-exempt bonds subject to the private-activity bond volume limit which are issued after such date.

5. Modify qualified zone academy bond provisions to provide similar bonds for the construction of schools for the Bureau of Indian Affairs of the Department of the Interior

Present Law

Tax-exempt bonds

In general

Interest on State or local bonds is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds (sec. 103).²⁰ Similar to other activities carried out or paid for by States and local governments, the construction, renovation, and operation of public schools is an activity eligible for financing with the proceeds of tax-exempt bonds.

Interest on bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person is taxable unless the purpose of the borrowing is approved specifically in the Code or in a non-Code provision of a revenue Act. These bonds are called "private activity bonds."²¹ The term "private person" includes the Federal Government and all other individuals and entities other than States or local governments.

²⁰ Interest on this debt is included in calculating the "adjusted current earnings" preference of the corporate alternative minimum tax.

²¹ Interest on private activity bonds (other than qualified 501(c)(3) bonds) is a preference item in calculating the alternative minimum tax.

Private activities eligible for financing with tax-exempt private activity bonds

Present law includes several exceptions permitting States or local governments to act as conduits providing tax-exempt financing for private activities. Both capital expenditures and limited working capital expenditures of charitable organizations described in section 501(c)(3) of the Code -- including elementary, secondary, and post-secondary schools -- may be financed with tax-exempt private activity bonds ("qualified 501(c)(3) bonds"). Bonds for section 501(c)(3) organizations are not subject to generally applicable State volume limits on most other private activity bonds.

States or local governments also may issue tax-exempt "exempt-facility bonds" to finance elementary and secondary public school facilities which are owned by private, for-profit corporations pursuant to public-private partnership agreements with a State or local educational agency. The term "school facility" includes school buildings and functionally related and subordinate facilities and land, including stadiums or other athletic facilities primarily used for school events, and depreciable personal property used in the school facility. The school facilities for which these bonds are issued must be operated by a public educational agency as part of a system of public schools. A "public private partnership agreement" is an arrangement under which the for-profit corporate party agrees to construct, rehabilitate, refurbish, or equip a school facility. The agreement also must provide that, at the end of the contract term, ownership of the bond-financed property is transferred to the public school agency for no additional consideration.

These exempt facility bonds are subject to annual limits separate and apart from the general volume cap for private activity bonds. The volume limit applicable to each State equals the greater of \$10 per State resident or \$5 million. Individual States decide how to allocate the bond authority to State and local government agencies. Unused bond authority may be carried forward, but can only be used for public school projects. This provision sunsets after December 31, 2010.

Arbitrage restrictions on tax-exempt bonds

The Federal income tax does not apply to the income of States and local governments that is derived from the exercise of an essential governmental function. To prevent these tax-exempt entities from issuing more Federally subsidized tax-exempt bonds than is necessary for the activity being financed or from issuing such bonds earlier than needed for the purpose of the borrowing, the Code includes arbitrage restrictions limiting the ability to profit from investment of tax-exempt bond proceeds. In general, arbitrage profits may be earned only during specified periods (e.g., defined "temporary periods" before funds are needed for the purpose of the borrowing) or on specified types of investments (e.g., "reasonably required reserve or replacement funds"). Subject to limited exceptions, profits that are earned during these periods or on such investments must be rebated to the Federal Government.

Present law includes three exceptions to the arbitrage rebate requirements applicable to education-related bonds. First, issuers of all types of tax-exempt bonds are not required to rebate arbitrage profits if all of the proceeds of the bonds are spent for the purpose of the borrowing

within six months after issuance.²² Second, in the case of bonds to finance certain construction activities, including school construction and renovation, the six-month period is extended to 24 months. Arbitrage profits earned on construction proceeds are not required to be rebated if all such proceeds (other than certain retainage amounts) are spent by the end of the 24-month period and prescribed intermediate spending percentages are satisfied.²³ Issuers qualifying for this “construction bond” exception may elect to be subject to a fixed penalty payment regime in lieu of rebate if they fail to satisfy the spending requirements.

Third, governmental bonds issued by “small” governments are not subject to the rebate requirement. Small governments are defined as general-purpose governmental units that issue no more than \$5 million of tax-exempt governmental bonds in a calendar year. The \$5 million limit is increased to \$15 million if at least \$10 million of the bonds are used to finance public schools.²⁴

Qualified zone academy bonds

As an alternative to traditional tax-exempt bonds, States and local governments are given the authority to issue “qualified zone academy bonds.” Under present law, a total of \$400 million of qualified zone academy bonds may be issued in each of 1998 through 2003. The \$400 million aggregate bond authority is allocated each year to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocates the credit to qualified zone academies within such State. A State may carry over any unused allocation for up to two years (three years for authority arising before 2000).

Certain financial institutions (i.e., banks, insurance companies, and corporations actively engaged in the business of lending money) that hold qualified zone academy bonds are entitled to a nonrefundable tax credit in an amount equal to a credit rate multiplied by the face amount of the bond. An eligible financial institution holding a qualified zone academy bond on the credit allowance date (i.e., each one-year anniversary of the issuance of the bond) is entitled to a credit. The credit amount is includible in gross income (as if it were a taxable interest payment on the bond), and the credit may be claimed against regular income tax and alternative minimum tax liability.

²² In the case of governmental bonds (including bonds to finance public schools), the six-month expenditure exception is treated as satisfied if at least 95 percent of the proceeds is spent within six months and the remaining five percent is spent within 12 months after the bonds are issued.

²³ Retainage amounts are limited to no more than five percent of the bond proceeds, and these amounts must be spent for the purpose of the borrowing no later than 36 months after the bonds are issued.

²⁴ The Small Business Job Protection Act of 1996 permitted issuance of the additional \$5 million in public school bonds by small governments. Previously, small governments were defined as governments that issued no more than \$5 million of governmental bonds without regard to the purpose of the financing.

The Treasury Department sets the credit rate daily at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer. The maximum term of the bonds also is determined by the Treasury Department, so that the present value of the obligation to repay the bond is 50 percent of the face value of the bond. Present value is determined using as a discount rate the average annual interest rate of tax-exempt obligations with a term of 10 years or more issued during the month.

“Qualified zone academy bonds” are defined as bonds issued by a State or local government, provided that: (1) at least 95 percent of the proceeds is used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a “qualified zone academy” and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds.

A school is a “qualified zone academy” if (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located in a designated empowerment zone or a designated enterprise community, or (b) it is reasonably expected that at least 35 percent of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

Description of Proposal

The proposal modifies the qualified zone academy bond program to allow eligible Indian tribes the authority to issue tribal school modernization bonds. The proceeds from tribal school modernization bonds are to be used for funding the construction, rehabilitation, or repair of tribal schools. The proceeds also may be used for (1) advance planning, design and engineering of the school, (2) payments to financial advisors, underwriters, attorneys, trustees and other professionals who provide assistance to the tribe in issuing the bonds and (3) certain other activities. The qualified tribal school modernization bond limitation for the calendar year 2003 is \$200 million and zero for calendar years thereafter. The qualified tribal school modernization bond limitation is to be allocated by the Treasury Department after consultation with the Secretary of Interior. Unused authority may be carried forward for up to two years.

As with qualified zone academy bonds, certain financial institutions (i.e., banks, insurance companies, and corporations actively engaged in the business of lending money) that hold qualified tribal school modernization bonds are entitled to a nonrefundable tax credit in an amount equal to a credit rate multiplied by the face amount of the bond. In lieu of interest, an eligible financial institution holding a qualified tribal school modernization bond on the credit allowance date (i.e., each one-year anniversary of the issuance of the bond) is entitled to a credit. The credit amount is includible in gross income (as if it were a taxable interest payment on the bond), and the credit may be claimed against regular income tax and alternative minimum tax liability.

As with qualified zone academy bonds, the Treasury Department sets the credit rate daily at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer. The maximum term of the bonds also is determined by the Treasury Department, so that the present value of the obligation to repay the bond is 50 percent of the face value of the bond. Present value is determined using as a discount rate the average annual interest rate of tax-exempt obligations with a term of 10 years or more issued during the month.

No principal payments on any qualified tribal school modernization bond will be required until the stated maturity of such bond. At that time, the entire outstanding principal shall become due and payable. Payment of principal is guaranteed solely by amounts deposited with the respective bond trustee. Any land or facilities purchased or improved with bond proceeds can not be mortgaged or used as collateral for such bonds.

Under the proposal, a bond is treated as a qualified tribal school modernization bond if: (1) 95 percent or more of the bond proceeds are to be used for the construction, rehabilitation or repair of school facility funded by the Bureau of Indian Affairs or for the acquisition of land on which such a facility is to be constructed with part of the proceeds of such issue, (2) the bond is issued by a tribal government; (3) the issuer designates such bond for purposes of this section; and (4) the term of the bonds does not exceed the maximum term allowable for such bonds.

To be eligible to issue qualified tribal school modernization bonds, a tribe must (1) prepare and submit to the Treasury Department and the Secretary of Interior a plan of construction that meets certain requirements;²⁵ (2) provide for quarterly and final inspection of the project by the Bureau of Indian Affairs; and (3) pledge that the facilities financed by such bond will be used primarily for elementary and secondary educational purposes for not less than the period such bond remains outstanding. Priority is given to projects described in the Education Facilities Replacement Construction Priorities List as of FY 2000 of the Bureau of Indian Affairs or any subsequent priorities list published in the Federal Register, or which meet the criteria for ranking schools as described in Instructions and Application for Replacement School Construction, Revision 6, dated February 6, 1999.

The proposal makes any tribal school modernization bond subject to a trust agreement between a tribe and a trustee. Under the trust agreement, the trustee is to act as a repository for the proceeds of the bonds, make payments to bond holders, and invest the funds received. In lieu of a private business contribution requirement, the proposal authorizes the Secretary of Interior to deposit not more than \$30 million into a tribal school modernization escrow account in FY 2003. It requires the Secretary of Interior to use any amounts deposited to make payments

²⁵ The plan of construction must contain a description of the construction to be undertaken with the funding, demonstrate that a comprehensive survey has been undertaken concerning the construction needs of the tribal school involved, contain assurances that the funding under the bond will be used only for the activities described in the plan, contain a response to the valuation criteria contained in Instructions and Application for Replacement School Construction, Revision 6, dated February 6, 1999; and contain any other reasonable and related information determined appropriate by the Secretary.

to trustees, or for advance planning and design. Trustees are to invest money received from the escrow account in obligations of or fully guaranteed by the United States. Trust agreement earnings are not subject to Federal income tax.

Effective Date

The proposal is effective on date of enactment with respect to bonds issued after December 31, 2002.

6. Qualified small business stock

Present Law

Under present law, individuals may exclude 50 percent (60 percent for certain empowerment zone businesses) of the gain from the sale of certain small business stock acquired at original issue and held for at least five years. The taxable portion of the gain is taxed at a maximum rate of 28 percent. Forty-two percent of the excluded gain is a minimum tax preference. The amount of gain eligible for the exclusion by an individual with respect to any corporation is the greater of (1) ten times the taxpayer's basis in the stock or (2) \$10 million. In order to qualify as a small business, when the stock is issued, the gross assets of the corporation may not exceed \$50 million. The corporation also must meet certain active trade or business requirements.

A qualifying trade or business is any trade or business other than (1) a trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or other trades or businesses based upon the reputation or skill of one or more of its employees; (2) banking, insurance, financing, leasing, investing, or similar business; (3) farming businesses, including raising or harvesting timber; (4) mining businesses; and (5) any business of operating a hotel, motel, or restaurant.

Description of Proposal

Under the proposal, any business engaged in the development or provision of a “critical technology” as (as defined in section 2500(6) of title 10, United States Code), including transportation security technologies, antiterrorism technologies, technologies enhancing security by improving methods of personal identification (including biometrics), or environmental technologies for pollution minimization, remediation, or waste management, is a qualifying business.

Also under the proposal, if an eligible critical technology business is located in a high out-migration county, the 50-percent exclusion of gain is increased to a 60-percent exclusion. A “high out-migration county” is a county located outside a metropolitan statistical area (as defined by the Office of Management and Budget) that experienced net population loss during the five-year period 1990 through 1994 and also during the five-year period 1995 through 1999.

Effective Date

The proposals apply to stock acquired after December 31, 2002.

7. Modification to the work opportunity tax credit

Present Law

Targeted groups eligible for the credit

The work opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The eight targeted groups are: (1) certain families eligible to receive benefits under the Temporary Assistance for Needy Families Program; (2) high-risk youth; (3) qualified ex-felons; (4) vocational rehabilitation referrals; (5) qualified summer youth employees; (6) qualified veterans; (7) certain members of families receiving food stamps; and (8) persons receiving certain Supplemental Security Income (SSI) benefits.

Vocational rehabilitation referrals are individuals who have a physical or mental disability that constitutes a substantial handicap to employment and who have been referred to the employer while receiving, or after completing, vocational rehabilitation services under an individualized, written rehabilitation plan under a State plan approved under the Rehabilitation Act of 1973 or under a rehabilitation plan for veterans carried out under Chapter 31 of Title 38, U.S. Code. Certification is provided by the designated local employment agency upon assurances from the vocation rehabilitation agency that the employee has met the above conditions.

A qualified food stamp recipient is an individual aged 18 but not aged 25 certified as being a member of a family either currently or recently receiving assistance under an eligible food stamp program.

Qualified wages

Generally, qualified wages are defined as cash wages paid by the employer to a member of a targeted group. The employer's deduction for wages is reduced by the amount of the credit.

Calculation of the credit

The credit equals 40 percent (25 percent for employment of 400 hours or less) of qualified first-year wages. Generally, qualified first-year wages are qualified wages (not in excess of \$6,000) attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee is \$2,400 (40 percent of the first \$6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is \$1,200 (40 percent of the first \$3,000 of qualified first-year wages).

Minimum employment period

No credit is allowed for qualified wages paid to employees who work less than 120 hours in the first year of employment.

Other rules

The work opportunity tax credit is not allowed for wages paid to a relative or dependent of the taxpayer. Also, wages paid to replacement workers during a strike or lockout are not eligible for the work opportunity tax credit. Wages paid to any employee during any period for which the employer received on-the-job training program payments with respect to that employee are not eligible for the work opportunity tax credit. The work opportunity tax credit generally is not allowed for wages paid to individuals who had previously been employed by the employer. In addition, many other technical rules apply.

Description of Proposal

The proposal adds an additional type of individual eligible for the credit under the category of vocational rehabilitation referrals. Under the proposal, certain individuals who have a physical or mental disability that constitutes a substantial handicap to employment and who are receiving vocational services or have completed an individual work plan developed by a private employment network as defined under section 1148(f) of the Social Security Act qualify as members of the vocational rehabilitation referral targeted group.

The proposal increases the age limit for qualified food stamp recipients. Therefore a food stamp recipient is an individual aged 18 but not aged 30 certified as being a member of a family either currently or recently receiving assistance under an eligible food stamp program.

Effective Date

The provision is effective for wages paid or incurred to a qualified individual who begins work for an employer after December 31, 2002.

8. Treatment of new markets venture capital companies for the new markets tax credit

Present Law

The Community Renewal Tax Relief Act of 2000 created a new tax credit for qualified equity investments made to acquire stock or a partnership interest in a selected community development entity ("CDE"). The Treasury Department is responsible for allocating the credit among eligible CDEs, and the maximum annual amount of qualifying equity investments that is eligible for the credit is capped as follows:

<u>Calendar Year</u>	<u>Maximum Qualifying Equity Investment</u>
2002-2003	\$1.5 billion per year
2004-2005	\$2.0 billion per year
2006-2007	\$3.5 billion per year

The amount of the tax credit to the investor (either the original purchaser or a subsequent holder) is (1) a five-percent credit for the year in which the equity interest is purchased from the CDE and the first two anniversary dates after the interest is purchased from the CDE, and (2) a six percent credit on each anniversary date thereafter for the following four years.

A CDE is any domestic corporation or partnership (1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons, (2) that maintains accountability to residents of low-income communities by their representation on any governing board or on any advisory board of the CDE, and (3) is certified by the Treasury Department as an eligible CDE. A specialized small business investment company and a community development financial institution are treated as satisfying the requirements for a CDE.

Description of Proposal

The proposal treats any conditionally approved new markets venture capital company (as defined in section 101 of the Community Renewal and New Markets Initiatives Act of 2001) as satisfying the requirements for a CDE.

Effective Date

The proposal is effective beginning on January 1, 2003.

F. Provisions to Simplify Excise Taxes

1. Simplification of excise tax imposed on bows and arrows

Present Law

The Code imposes an excise tax of 11 percent on the sale by a manufacturer, producer or importer of any bow with a draw rate of 10 pounds or more (sec. 4161(b)(1)(A)). An excise tax of 12.4 percent is imposed on the sale by a manufacturer or importer of any shaft, point,nock, or vane designed for use as part of an arrow which after its assembly (1) is over 18 inches long, or (2) is designed for use with a taxable bow (if shorter than 18 inches) (sec. 4161(b)(2)). No tax is imposed on finished arrows. An 11-percent excise tax also is imposed on any part of an accessory for taxable bows and on quivers for use with arrows (1) over 18 inches long or (2) designed for use with a taxable bow (if shorter than 18 inches) (sec. 4161(b)(1)(B)).

Description of Proposal

The proposal increases the minimum draw weight for a taxable bow from 10 pounds to 30 pounds. The proposal also imposes an excise tax of 12 percent on arrows generally. An arrow for this purpose would be defined as an arrow shaft to which additional components are attached. The present law 12.4-percent excise tax on certain arrow components is unchanged by the proposal. The proposal provides that the 12-percent excise tax on arrows would not apply if the arrow contains an arrow shaft that was subject to the tax on arrow components. Finally, the proposal subjects certain broadheads (a type of arrow point) to an excise tax equal to 11 percent of the sales price instead of 12.4 percent.

Effective Date

The proposal is effective for articles sold by the manufacturer, producer, or importer after December 31, 2002.

2. Custom gunsmiths

Present Law

The Code imposes an excise tax upon the sale by the manufacturer, producer or importer of certain firearms and ammunition (sec. 4181). Pistols and revolvers are taxable at 10 percent. Firearms (other than pistols and revolvers), shells, and cartridges are taxable at 11 percent. The excise tax for firearms imposed on manufacturers, producers, and importers does not apply to machine guns and short barreled firearms. Sales to the Defense Department of firearms, pistols, revolvers, shells and cartridges also are exempt from the tax (sec. 4182).

Description of Proposal

The proposal exempts from the firearms excise tax articles manufactured, produced, or imported by a person who manufactures, produces, and imports less than 50 of such articles during the calendar year. Controlled groups are treated as a single person for determining the 50-article limit.

Effective Date

The proposal is effective for articles sold by the manufacturer, producer, or importer after December 31, 2002. No inference is intended from the prospective effective date of this proposal as to the proper treatment of pre-effective date sales.

3. Repeal special occupational taxes on producers and marketers of alcoholic beverages

Present Law

Under present law, special occupational taxes are imposed on producers and others engaged in the marketing of distilled spirits, wine, and beer. These excise taxes are imposed as part of a broader Federal tax and regulatory engine governing the production and marketing of alcoholic beverages. The special occupational taxes are payable annually, on July 1 of each year. The present tax rates are as follows:

Producers:

Distilled spirits and wines (sec. 5081) \$1,000 per year, per premise

Brewers (sec. 5091) \$1,000 per year, per premise

Wholesale dealers (sec. 5111):

Liquors, wines, or beer \$500 per year

Retail dealers (sec. 5121):

Liquors, wines, or beer \$250 per year

Nonbeverage use of distilled spirits (sec. 5131): \$500 per year

Industrial use of distilled spirits (sec. 5276): \$250 per year

Description of Proposal

The special occupational taxes on producers and marketers of alcoholic beverages are repealed. For purposes of the recordkeeping requirements for wholesale and retail liquor dealers, the proposal provides a rebuttable presumption that a person who sells, or offers for sale distilled spirits, wine, or beer, in quantities of 20 wine gallons or more to the same person at the same time, is engaged in the business of a wholesale dealer in liquors or a wholesale dealer in beer. In addition, the proposal makes it unlawful for any liquor dealer to purchase distilled spirits from any person other than a wholesale liquor dealer subject to the recordkeeping requirements.

Effective Date

The proposal is effective on July 1, 2003. The proposal does not affect liability for taxes imposed with respect to periods before July 1, 2003.

4. Treat tribal governments the same as State governments for purposes of the Federal wagering excise and occupational taxes

Present Law

Two excise taxes generally apply to wagering activities: a wager tax and an occupational tax. Section 4401 imposes a tax of 0.25 percent on any wager authorized under the law of the State in which the wager is accepted (the rate increases to 2.0 percent of any wager that is not so authorized). Certain wagering activities licensed or conducted by States are exempt from these excise taxes.²⁶

The Code also imposes a tax of \$50 per year (the rate increases to \$500 per year where unauthorized wagers are accepted) for each person liable for the tax imposed under section 4401 and for each person who is engaged in receiving wagers for or on behalf of a person liable to pay the tax under section 4401 (sec. 4411).

The United States Supreme Court recently resolved a split of authority²⁷ regarding whether pull-tab games conducted by Indian tribes are exempt from these wagering and occupational excise taxes. The Court held that the Indian Gaming Regulatory Act does not exempt tribes from these taxes.²⁸

Section 7871 expressly provides that Indian tribal governments are treated as States for certain tax purposes. First, tribal governments may be recipients of deductible charitable donations for income, estate and gift tax purposes. Second, tribal governments are extended the treatment provided to States under the following excise taxes: tax on special fuels, manufacturers excise taxes, communications excise tax, and tax on use of certain highway vehicles. Special treatment relating to excise taxes is available to tribal governments only with regard to transactions involving the exercise of an essential governmental function by the Indian tribal government. Third, taxes paid to Indian tribal governments are deductible for income tax

²⁶ Wagers placed with a paramutuel wagering enterprise licensed under State law, wagers placed in certain coin-operated devices, and wagers placed with certain State-conducted lotteries are exempt under sec. 4402.

²⁷ The Court of Appeals for the Federal Circuit in *Little Six, Inc. & Shakopee Mdewakanton Sioux (Dakota) Community v. United States*, 210 F. 3d 1361 (Fed. Cir. 2000) held that Indian Gaming Regulatory Act, at 25 U.S.C. sec. 2719(d)(1), provided tribes with the same exemption from Federal excise taxes enjoyed by the States for lotteries. The Court of Appeals for the Tenth Circuit held that the Indian Gaming Regulatory Act did not provide tribes with an exception in *The Chickasaw Nation v. United States*, 208 F. 3d 871 (10th Cir. 2000), *cert. granted*, January 22, 2001.

²⁸ *Chickasaw Nation v. United States*, 534 U.S. 84 (2001). Affirming the Tenth Circuit, the Supreme Court rejected the argument that the Indian Gaming Regulatory Act exempted the Chickasaw and Choctow nations from the excise taxes in chapter 35 of the Code, finding no such exemption.

purposes to the same extent as States taxes. Fourth, Indian tribal governments may issue tax-exempt bonds and private activity bonds under certain conditions.

Description of Proposal

The proposal treats Indian tribes as States for purposes of chapter 35 of the Code (relating to wagering). As a result, the wagering and occupational excise taxes would not apply to Indian tribes.

Effective Date

The proposal is effective July 1, 2003, but does not apply to taxes imposed for periods before such date.

G. Rate Reduction For Asbestos-Related Settlement Funds

Present Law

In general, section 461(h) provides that liabilities are not treated as incurred prior to the time when economic performance occurs. In the case of the taxpayer's liability to another person, arising under any workers compensation act or any tort, economic performance occurs as payments to such person are made, except to the extent provided in regulations.

Section 468(B) provides that under certain limited circumstances, a qualified payment to a designated settlement fund that extinguishes tort liability of the taxpayer constitutes economic performance with respect to such liability. In addition, the regulations under section 468(B) provide that a payment to a qualified settlement fund to resolve or satisfy certain liabilities constitutes economic performance with respect to such liability.

A designated settlement fund means a fund (1) which is established pursuant to a court order, (2) which extinguishes completely the taxpayer's tort liability with respect to a class of claimants, as determined by the court, (3) which is managed and controlled by persons unrelated to the taxpayer, (4) in which the taxpayer does not have a beneficial interest in the income or corpus, and (5) to which no amount may be transferred other than qualified payments.

The regulations define a qualified settlement fund as a fund, account, or trust (1) which is established pursuant to an order of, or approved by, a governmental authority and must be subject to the continuing jurisdiction of that governmental authority, (2) which is established to resolve or satisfy one or more claims that result from an event, or series of events, that has occurred and that gives rise to liabilities under the Comprehensive Environmental Response, Compensation and Liability Act, out of a tort, breach of contract (which is not defined in the same manner as in Treasury Regulation section 1.461-4(g)(2)(i)), or violation of law; or designated by the Commissioner in a revenue ruling or revenue procedure, and (3) which must be a trust under state law or its assets must be segregated from other assets of the transferor (and related persons).

In general, a qualified payment means cash or property, other than indebtedness of the taxpayer (or a related party), which is contributed to a designated settlement fund or a qualified settlement fund. If indebtedness of the taxpayer (or related party) is contributed to a qualified settlement fund, economic performance occurs as the transferor (or related party) makes principal payments on the debt. Stock of the taxpayer (or related party) is not a qualified payment if contributed to a designated settlement fund.

A designated or qualified settlement fund is taxed as a separate entity at the maximum trust rate. The fund is subject to tax on modified gross income, which is defined as gross income computed with certain modifications. One modification excludes amounts transferred to the qualified settlement fund by, or on behalf of, the transferor. The other modifications are deductions for administrative costs and other incidental expenses incurred in connection with the operation of the fund; losses sustained by the fund in connection with the sale, exchange, or worthlessness of property; and specially defined net operating losses. Thus, distributions to claimants are not deductible.

A contribution of property to a designated or qualified settlement fund is treated as if the taxpayer sold the property for fair market value and donated the proceeds to the fund. Thus, the taxpayer's deduction is limited to fair market value. The taxpayer recognizes gain or loss at the time property is contributed, and the fund takes a fair market value basis in the property.

No deduction is allowed under this provision for payment to a fund of an amount received from the settlement of an insurance claim, if the amount received is excluded from the taxpayer's gross income.

Description of Proposal

The proposal provides a Federal income tax rate of 15 percent on the gross income (less permitted expenses) of a designated settlement fund (or a qualified settlement fund as defined under the regulations of section 468B) established for the principle purpose of resolving and satisfying present and future claims relating to asbestos.

Effective Date

The proposal is effective shall apply to taxable years ending after December 31, 2002.

H. Provisions to Discourage Corporate Expatriation

1. Tax treatment of inversion transactions

Present Law

Determination of corporate residence

The U.S. tax treatment of a multinational corporate group depends significantly on whether the top-tier “parent” corporation of the group is domestic or foreign. For purposes of U.S. tax law, a corporation is treated as domestic if it is incorporated under the law of the United States or of any State. All other corporations (i.e., those incorporated under the laws of foreign countries) are treated as foreign. Thus, place of incorporation determines whether a corporation is treated as domestic or foreign for purposes of U.S. tax law, irrespective of other factors that might be thought to bear on a corporation’s “nationality,” such as the location of the corporation’s management activities, employees, business assets, operations, or revenue sources, the exchanges on which the corporation’s stock is traded, or the residence of the corporation’s managers and shareholders.

U.S. taxation of domestic corporations

The United States employs a “worldwide” tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. In order to mitigate the double taxation that may arise from taxing the foreign-source income of a domestic corporation, a foreign tax credit for income taxes paid to foreign countries is provided to reduce or eliminate the U.S. tax owed on such income, subject to certain limitations.

Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income is generally deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F (sections 951-964) and the passive foreign investment company rules (sections 1291-1298). A foreign tax credit is generally available to offset, in whole or in part, the U.S. tax owed on this foreign-source income, whether repatriated as an actual dividend or included under one of the anti-deferral regimes.

U.S. taxation of foreign corporations

The United States taxes foreign corporations only on income that has a sufficient nexus to the United States. Thus, a foreign corporation is generally subject to U.S. tax only on income that is “effectively connected” with the conduct of a trade or business in the United States. Such “effectively connected income” generally is taxed in the same manner and at the same rates as the income of a U.S. corporation. An applicable tax treaty may limit the imposition of U.S. tax

on business operations of a foreign corporation to cases in which the business is conducted through a “permanent establishment” in the United States.

In addition, foreign corporations generally are subject to a gross-basis U.S. tax at a flat 30-percent rate on the receipt of interest, dividends, rents, royalties, and certain similar types of income derived from U.S. sources, subject to certain exceptions. The tax generally is collected by means of withholding by the person making the payment. This tax may be reduced or eliminated under an applicable tax treaty.

U.S. tax treatment of inversion transactions

Under present law, U.S. corporations may reincorporate in foreign jurisdictions and thereby replace the U.S. parent corporation of a multinational corporate group with a foreign parent corporation. These transactions are commonly referred to as “inversion” transactions. Inversion transactions may take many different forms, including stock inversions, asset inversions, and various combinations of and variations on the two. Most of the known transactions to date have been stock inversions. In one example of a stock inversion, a U.S. corporation forms a foreign corporation, which in turn forms a domestic merger subsidiary. The domestic merger subsidiary then merges into the U.S. corporation, with the U.S. corporation surviving, now as a subsidiary of the new foreign corporation. The U.S. corporation’s shareholders receive shares of the foreign corporation and are treated as having exchanged their U.S. corporation shares for the foreign corporation shares. An asset inversion reaches a similar result, but through a direct merger of the top-tier U.S. corporation into a new foreign corporation, among other possible forms. An inversion transaction may be accompanied or followed by further restructuring of the corporate group. For example, in the case of a stock inversion, in order to remove income from foreign operations from the U.S. taxing jurisdiction, the U.S. corporation may transfer some or all of its foreign subsidiaries directly to the new foreign parent corporation or other related foreign corporations.

In addition to removing foreign operations from the U.S. taxing jurisdiction, the corporate group may derive further advantage from the inverted structure by reducing U.S. tax on U.S.-source income through various “earnings stripping” or other transactions. This may include earnings stripping through payment by a U.S. corporation of deductible amounts such as interest, royalties, rents, or management service fees to the new foreign parent or other foreign affiliates. In this respect, the post-inversion structure enables the group to employ the same tax-reduction strategies that are available to other multinational corporate groups with foreign parents and U.S. subsidiaries, subject to the same limitations. These limitations under present law include section 163(j), which limits the deductibility of certain interest paid to related parties, if the payor’s debt-equity ratio exceeds 1.5 to 1 and the payor’s net interest expense exceeds 50 percent of its “adjusted taxable income.” More generally, section 482 and the regulations thereunder require that all transactions between related parties be conducted on terms consistent with an “arm’s length” standard, and permit the Secretary of the Treasury to reallocate income and deductions among such parties if that standard is not met.

Inversion transactions may give rise to immediate U.S. tax consequences at the shareholder and/or the corporate level, depending on the type of inversion. In stock inversions, the U.S. shareholders generally recognize gain (but not loss) under section 367(a), based on the

difference between the fair market value of the foreign corporation shares received and the adjusted basis of the domestic corporation stock exchanged. To the extent that a corporation's share value has declined, and/or it has many foreign or tax-exempt shareholders, the impact of this section 367(a) "toll charge" is reduced. The transfer of foreign subsidiaries or other assets to the foreign parent corporation also may give rise to U.S. tax consequences at the corporate level (e.g., gain recognition and earnings and profits inclusions under sections 1001, 311(b), 304, 367, 1248 or other provisions). The tax on any income recognized as a result of these restructurings may be reduced or eliminated through the use of net operating losses, foreign tax credits, and other tax attributes.

In asset inversions, the U.S. corporation generally recognizes gain (but not loss) under section 367(a) as though it had sold all of its assets, but the shareholders generally do not recognize gain or loss, assuming the transaction meets the requirements of a reorganization under section 368.

Description of Proposal

In general

The proposal defines two different types of corporate inversion transactions and establishes a different set of consequences for each type. Certain partnership transactions also are covered.

Transactions involving at least 80 percent identity of stock ownership

The first type of inversion is a transaction in which, pursuant to a plan or a series of related transactions: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity; (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 80 percent or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50 percent ownership (i.e., the "expanded affiliated group"), does not have substantial business activities in the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group. The provision denies the intended tax benefits of this type of inversion by deeming the top-tier foreign corporation to be a domestic corporation for all purposes of the Code.²⁹

In determining whether a transaction would meet the definition of an inversion under the provision, stock held by members of the expanded affiliated group that includes the foreign incorporated entity is disregarded. For example, if the former top-tier U.S. corporation receives stock of the foreign incorporated entity (e.g., so-called "hook" stock), the stock would not be

²⁹ Since the top-tier foreign corporation is treated for all purposes of the Code as domestic, the shareholder-level "toll charge" of sec. 367(a) does not apply to these inversion transactions. However, regulated investment companies and certain similar entities are allowed to elect to recognize gain as if sec. 367(a) did apply. This election is available for the calendar year of enactment and, if enactment occurs after October 31, the succeeding calendar year.

considered in determining whether the transaction meets the definition. Similarly, if a U.S. parent corporation converts an existing wholly owned U.S. subsidiary into a wholly owned controlled foreign corporation, the stock of such foreign corporation would be disregarded, and the definition would not be met. Stock sold in a public offering related to the transaction also is disregarded for these purposes. Acquisitions with respect to a domestic corporation or partnership are deemed to be “pursuant to a plan” if they occur within the four-year period beginning on the date which is two years before the ownership threshold under the provision is met with respect to such corporation or partnership.

Transfers of properties or liabilities as part of a plan a principal purpose of which is to avoid the purposes of the provision are disregarded. In addition, the Treasury Secretary is granted authority to prevent the avoidance of the purposes of the provision, including avoidance through the use of related persons, pass-through or other noncorporate entities, or other intermediaries, and through transactions designed to qualify or disqualify a person as a related person or a member of an expanded affiliated group. Similarly, the Treasury Secretary is granted authority to treat certain non-stock instruments as stock, and certain stock as not stock, where necessary to carry out the purposes of the provision.

Transactions involving greater than 50 percent but less than 80 percent identity of stock ownership

The second type of inversion is a transaction that would meet the definition of an inversion transaction described above, except that the 80-percent ownership threshold is not met. In such a case, if a greater-than-50-percent ownership threshold is met, then a second set of rules applies to the inversion. Under these rules, the inversion transaction is respected (i.e., the foreign corporation is treated as foreign), but: (1) any applicable corporate-level “toll charges” for establishing the inverted structure may not be offset by tax attributes such as net operating losses or foreign tax credits; (2) the IRS is given expanded authority to monitor related-party transactions that may be used to reduce U.S. tax on U.S.-source income going forward; and (3) section 163(j), relating to “earnings stripping” through related-party debt, is strengthened. These measures generally apply for a 10-year period following the inversion transaction. In addition, inverting entities are required to provide information to shareholders or partners and the IRS with respect to the inversion transaction.

With respect to “toll charges,” any applicable corporate-level income or gain required to be recognized under sections 304, 311(b), 367, 1001, 1248, or any other provision with respect to the transfer of controlled foreign corporation stock or other assets by a U.S. corporation as part of the inversion transaction or after such transaction to a related foreign person is taxable, without offset by any tax attributes (e.g., net operating losses or foreign tax credits). To the extent provided in regulations, this rule will not apply to certain transfers of inventory and similar transactions conducted in the ordinary course of the taxpayer’s business.

In order to enhance IRS monitoring of related-party transactions, the provision establishes a new pre-filing procedure. Under this procedure, the taxpayer will be required annually to submit an application to the IRS for an agreement that all return positions to be taken by the taxpayer with respect to related-party transactions comply with all relevant provisions of the Code, including sections 163(j), 267(a)(3), 482, and 845. The Treasury Secretary is given the

authority to specify the form, content, and supporting information required for this application, as well as the timing for its submission.

The IRS will be required to take one of the following three actions within 90 days of receiving a complete application from a taxpayer: (1) conclude an agreement with the taxpayer that the return positions to be taken with respect to related-party transactions comply with all relevant provisions of the Code; (2) advise the taxpayer that the IRS is satisfied that the application was made in good faith and substantially complies with the requirements set forth by the Treasury Secretary for such an application, but that the IRS reserves substantive judgment as to the tax treatment of the relevant transactions pending the normal audit process; or (3) advise the taxpayer that the IRS has concluded that the application was not made in good faith or does not substantially comply with the requirements set forth by the Treasury Secretary.

In the case of a compliance failure described in (3) above (and in cases in which the taxpayer fails to submit an application), the following sanctions will apply for the taxable year for which the application was required: (1) no deductions or additions to basis or cost of goods sold for payments to foreign related parties will be permitted; (2) any transfers or licenses of intangible property to related foreign parties will be disregarded; and (3) any cost-sharing arrangements will not be respected.

If the IRS fails to act on the taxpayer's application within 90 days of receipt, then the taxpayer will be treated as having submitted in good faith an application that substantially complies with the above-referenced requirements. Thus, the deduction disallowance and other sanctions described above will not apply, but the IRS will be able to examine the transactions at issue under the normal audit process. The IRS is authorized to request that the taxpayer extend this 90-day deadline in cases in which the IRS believes that such an extension might help the parties to reach an agreement.

The "earnings stripping" rules of section 163(j), which deny or defer deductions for certain interest paid to foreign related parties, are strengthened for inverted corporations. With respect to such corporations, the provision eliminates the debt-equity threshold generally applicable under section 163(j) and reduces the 50-percent thresholds for "excess interest expense" and "excess limitation" to 25 percent.

In cases in which a U.S. corporate group acquires subsidiaries or other assets from an unrelated inverted corporate group, the provisions described above generally do not apply to the acquiring U.S. corporate group or its related parties (including the newly acquired subsidiaries or assets) by reason of acquiring the subsidiaries or assets that were connected with the inversion transaction. The Treasury Secretary is given authority to issue regulations appropriate to carry out the purposes of this provision and to prevent its abuse.

Partnership transactions

Under the proposal, both types of inversion transactions include certain partnership transactions. Specifically, both parts of the provision apply to transactions in which a foreign-incorporated entity acquires substantially all of the properties constituting a trade or business of a domestic partnership, if after the acquisition at least 80 percent (or more than 50 percent but less

than 80 percent, as the case may be) of the stock of the entity is held by former partners of the partnership (by reason of holding their partnership interests), and the “substantial business activities” test is not met. For purposes of determining whether these tests are met, all partnerships that are under common control within the meaning of section 482 are treated as one partnership, except as provided otherwise in regulations. In addition, the modified “toll charge” provisions apply at the partner level.

Effective Date

The regime applicable to transactions involving at least 80 percent identity of ownership applies to inversion transactions completed after March 20, 2002. The rules for inversion transactions involving greater-than-50-percent identity of ownership apply to inversion transactions completed after 1996 that meet the 50-percent test and to inversion transactions completed after 1996 that would have met the 80-percent test but for the March 20, 2002 date.

2. Reinsurance agreements

Present Law

In the case of a reinsurance agreement between two or more related persons, present law provides the Treasury Secretary with authority to allocate among the parties or recharacterize income (whether investment income, premium or otherwise), deductions, assets, reserves, credits and any other items related to the reinsurance agreement, or make any other adjustment, in order to reflect the proper source and character of the items for each party.³⁰ For this purpose, related persons are defined as in section 482. Thus, persons are related if they are organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) that are owned or controlled directly or indirectly by the same interests. The provision may apply to a contract even if one of the related parties is not a domestic company.³¹ In addition, the provision also permits such allocation, recharacterization, or other adjustments in a case in which one of the parties to a reinsurance agreement is, with respect to any contract covered by the agreement, in effect an agent of another party to the agreement, or a conduit between related persons.

Description of Proposal

The proposal clarifies the rules of section 845, relating to authority for the Treasury Secretary to allocate items among the parties to a reinsurance agreement, recharacterize items, or make any other adjustment, in order to reflect the proper source and character of the items for each party. The proposal authorizes such allocation, recharacterization, or other adjustment, in order to reflect the proper source, character or amount of the item. It is intended that this

³⁰ Sec. 845(a).

³¹ See S. Rep. No. 97-494, "Tax Equity and Fiscal Responsibility Act of 1982," July 12, 1982, 337 (describing provisions relating to the repeal of modified coinsurance provisions).

authority³² be exercised in a manner similar to the authority under section 482 for the Treasury Secretary to make adjustments between related parties. It is intended that this authority be applied in situations in which the related persons (or agents or conduits) are engaged in cross-border transactions that require allocation, recharacterization, or other adjustments in order to reflect the proper source, character or amount of the item or items. No inference is intended that present law does not provide this authority with respect to reinsurance agreements.

No regulations have been issued under section 845(a). It is expected that the Treasury Department will issue regulations under section 845(a) to address effectively the allocation of income (whether investment income, premium or otherwise) and other items, the recharacterization of such items, or any other adjustment necessary to reflect the proper amount, source or character of the item.

Effective Date

The provision is effective for any risk reinsured after April 11, 2002.

3. Excise tax on stock compensation of insiders of inverted corporations

Present Law

The income taxation of a nonstatutory³³ compensatory stock option is determined under the rules that apply to property transferred in connection with the performance of services (sec. 83). If a nonstatutory stock option does not have a readily ascertainable fair market value at the time of grant, which is generally the case unless the option is actively traded on an established market, no amount is included in the gross income of the recipient with respect to the option until the recipient exercises the option.³⁴ Upon exercise of such an option, the excess of the fair market value of the stock purchased over the option price is included in the recipient's gross income as ordinary income in such taxable year.

The tax treatment of other forms of stock-based compensation (e.g., restricted stock and stock appreciation rights) is also determined under section 83. The excess of the fair market value over the amount paid (if any) for such property is generally includable in gross income in the first taxable year in which the rights to the property are transferable or are not subject to substantial risk of forfeiture.

³² The authority to allocate, recharacterize or make other adjustments was granted in connection with the repeal of provisions relating to modified coinsurance transactions.

³³ Nonstatutory stock options refer to stock options other than incentive stock options and employee stock purchase plans, the taxation of which is determined under sections 421-424.

³⁴ If an individual receives a grant of a nonstatutory option that has a readily ascertainable fair market value at the time the option is granted, the excess of the fair market value of the option over the amount paid for the option is included in the recipient's gross income as ordinary income in the first taxable year in which the option is either transferable or not subject to a substantial risk of forfeiture.

Shareholders are generally required to recognize gain upon stock inversion transactions. An inversion transaction is generally not a taxable event for holders of stock options and other stock-based compensation.

Description of Proposal

Under the proposal, specified holders of stock options and other stock-based compensation are subject to an excise tax upon certain inversion transactions. The proposal imposes a 20 percent excise tax on the value of specified stock compensation held (directly or indirectly) by or for the benefit of a disqualified individual, or a member of such individual's family, at any time during the 12-month period beginning six months before the corporation's inversion date. Specified stock compensation is treated as held for the benefit of a disqualified individual if such compensation is held by an entity, e.g., a partnership or trust, in which the individual, or a member of the individual's family, has an ownership interest.

A disqualified individual is any individual who, with respect to a corporation, is, at any time during the 12-month period beginning on the date which is six months before the inversion date, subject to the requirements of section 16(a) of the Securities and Exchange Act of 1934 with respect to the corporation, or any member of the corporation's expanded affiliated group,³⁵ or would be subject to such requirements if the corporation (or member) were an issuer of equity securities referred to in section 16(a). Disqualified individuals generally include officers (as defined by section 16(a)),³⁶ directors, and 10-percent owners of private and publicly-held corporations.

The excise tax is imposed on a disqualified individual of an inverted corporation only if gain (if any) is recognized in whole or part by any shareholder by reason of either the 80 percent or 50 percent identity of stock ownership corporate inversion transactions previously described in the proposal.

Specified stock compensation subject to the excise tax includes any payment³⁷ (or right to payment) granted by the inverted corporation (or any member of the corporation's expanded affiliated group) to any person in connection with the performance of services by a disqualified individual for such corporation (or member of the corporation's expanded affiliated group) if the value of the payment or right is based on, or determined by reference to, the value or change in

³⁵ An expanded affiliated group is an affiliated group (under section 1504) except that such group is determined without regard to the exceptions for certain corporations and is determined applying a greater than 50 percent threshold, in lieu of the 80 percent test.

³⁶ An officer is defined as the president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions.

³⁷ Under the proposal, any transfer of property is treated as a payment and any right to a transfer of property is treated as a right to a payment.

value of stock of such corporation (or any member of the corporation's expanded affiliated group). In determining whether such compensation exists and valuing such compensation, all restrictions, other than non-lapse restrictions, are ignored. Thus, the excise tax applies, and the value subject to the tax is determined, without regard to whether such specified stock compensation is subject to a substantial risk of forfeiture or is exercisable at the time of the inversion transaction. Specified stock compensation includes compensatory stock and restricted stock grants, compensatory stock options, and other forms of stock-based compensation, including stock appreciation rights, phantom stock, and phantom stock options. Specified stock compensation also includes nonqualified deferred compensation that is treated as though it were invested in stock or stock options of the inverting corporation (or member). For example, the proposal applies to a disqualified individual's deferred compensation if company stock is one of the actual or deemed investment options under the nonqualified deferred compensation plan.

Specified stock compensation includes a compensation arrangement that gives the disqualified individual an economic stake substantially similar to that of a corporate shareholder. Thus, the excise tax does not apply where a payment is simply triggered by a target value of the corporation's stock or where a payment depends on a performance measure other than the value of the corporation's stock. Similarly, the tax does not apply if the amount of the payment is not directly measured by the value of the stock or an increase in the value of the stock. For example, an arrangement under which a disqualified individual is paid a cash bonus of \$500,000 if the corporation's stock increased in value by 25 percent over two years or \$1,000,000 if the stock increased by 33 percent over two years is not specified stock compensation, even though the amount of the bonus generally is keyed to an increase in the value of the stock. By contrast, an arrangement under which a disqualified individual is paid a cash bonus equal to \$10,000 for every \$1 increase in the share price of the corporation's stock is subject to the proposal because the direct connection between the compensation amount and the value of the corporation's stock gives the disqualified individual an economic stake substantially similar to that of a shareholder.

The excise tax applies to any such specified stock compensation previously granted to a disqualified individual but cancelled or cashed-out within the six-month period ending with the inversion transaction, and to any specified stock compensation awarded in the six-month period beginning with the inversion transaction. As a result, for example, if a corporation were to cancel outstanding options three months before the transaction and then reissue comparable options three months after the transaction, the tax applies both to the cancelled options and the newly granted options. It is intended that the Secretary issue guidance to avoid double counting with respect to specified stock compensation that is cancelled and then regranted during the applicable twelve-month period.

Specified stock compensation subject to the tax does not include a statutory stock option or any payment or right from a qualified retirement plan or annuity, a tax-sheltered annuity, a simplified employee pension, or a simple retirement account. In addition, under the proposal, the excise tax does not apply to any stock option that is exercised during the six-month period before the inversion or to any stock acquired pursuant to such exercise. The excise tax also does not apply to any specified stock compensation which is sold, exchanged, distributed or cashed-out during such period in a transaction in which gain or loss is recognized in full.

For specified stock compensation held on the inversion date, the amount of the tax is determined based on the value of the compensation on such date. The tax imposed on specified stock compensation cancelled during the six-month period before the inversion date is determined based on the value of the compensation on the day before such cancellation, while specified stock compensation granted after the inversion date is valued on the date granted. Under the proposal, the cancellation of a non-lapse restriction is treated as a grant.

The value of the specified stock compensation on which the excise tax is imposed is the fair value in the case of stock options (including warrants and other similar rights to acquire stock) and stock appreciation rights and the fair market value for all other forms of compensation. For purposes of the tax, the fair value of an option (or a warrant or other similar right to acquire stock) or a stock appreciation right is determined using an appropriate option-pricing model, as specified or permitted by the Secretary, that takes into account the stock price at the valuation date; the exercise price under the option; the remaining term of the option; the volatility of the underlying stock and the expected dividends on it; and the risk-free interest rate over the remaining term of the option. Options that have no intrinsic value (or “spread”) because the exercise price under the option equals or exceeds the fair market value of the stock at valuation nevertheless have a fair value and are subject to tax under the proposal. The value of other forms of compensation, such as phantom stock or restricted stock, are the fair market value of the stock as of the date of the inversion transaction. The value of any deferred compensation that could be valued by reference to stock is the amount that the disqualified individual would receive if the plan were to distribute all such deferred compensation in a single sum on the date of the inversion transaction (or the date of cancellation or grant, if applicable). It is expected that the Secretary issue guidance on valuation of specified stock compensation, including guidance similar to the revenue procedures issued under section 280G, except that the guidance would not permit the use of a term other than the full remaining term. Pending the issuance of guidance, it is intended that taxpayers could rely on the revenue procedures issued under section 280G (except that the full remaining term must be used).

The excise tax also applies to any payment by the inverted corporation or any member of the expanded affiliated group made to an individual, directly or indirectly, in respect of the tax. Whether a payment is made in respect of the tax is determined under all of the facts and circumstances. Any payment made to keep the individual in the same after-tax position that the individual would have been in had the tax not applied is a payment made in respect of the tax. This includes direct payments of the tax and payments to reimburse the individual for payment of the tax. It is expected that the Secretary issue guidance on determining when a payment is made in respect of the tax and that such guidance would include certain factors that give rise to a rebuttable presumption that a payment is made in respect of the tax, including a rebuttable presumption that if the payment is contingent on the inversion transaction, it is made in respect to the tax. Any payment made in respect of the tax is includible in the income of the individual, but is not deductible by the corporation.

To the extent that a disqualified individual is also a covered employee under section 162(m), the \$1,000,000 limit on the deduction allowed for employee remuneration for such employee is reduced by the amount of any payment (including reimbursements) made in respect of the tax under the proposal. As discussed above, this includes direct payments of the tax and payments to reimburse the individual for payment of the tax.

The payment of the excise tax has no effect on the subsequent tax treatment of any specified stock compensation. Thus, the payment of the tax has no effect on the individual's basis in any specified stock compensation and no effect on the tax treatment for the individual at the time of exercise of an option or payment of any specified stock compensation, or at the time of any lapse or forfeiture of such specified stock compensation. The payment of the tax is not deductible and has no effect on any deduction that might be allowed at the time of any future exercise or payment.

Under the proposal, the Secretary is authorized to issue regulations as may be necessary or appropriate to carry out the purposes of the section.

Effective Date

The proposal is effective as of July 11, 2002, except that periods before July 11, 2002, are not taken into account in applying the tax to specified stock compensation held or cancelled during the six-month period before the inversion date.

I. Provisions to Curtail Tax Shelters

1. Clarification of the economic substance doctrine

Present Law

In general

The Code provides specific rules regarding the computation of taxable income, including the amount, timing, source, and character of items of income, gain, loss and deduction. These rules are designed to provide for the computation of taxable income in a manner that provides for a degree of specificity to both taxpayers and the government. Taxpayers generally may plan their transactions in reliance on these rules to determine the federal income tax consequences arising from the transactions.

In addition to the statutory provisions, courts have developed several doctrines that can be applied to deny the tax benefits of tax motivated transactions, notwithstanding that the transaction may satisfy the literal requirements of a specific tax provision. The common-law doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts and the IRS. Although these doctrines serve an important role in the administration of the tax system, invocation of these doctrines can be seen as at odds with an objective, “rule-based” system of taxation. Nonetheless, courts have applied the doctrines to deny tax benefits arising from certain transactions.³⁸

A common-law doctrine applied with increasing frequency is the “economic substance” doctrine. In general, this doctrine denies tax benefits in transactions that do not result in a meaningful change to the taxpayer’s economic position other than a purported reduction in federal income tax.³⁹

Economic substance doctrine

Courts generally deny claimed tax benefits if the transaction that gives rise to those benefits lacks economic substance independent of tax considerations -- notwithstanding that the purported activity actually occurred. The Tax Court has described the doctrine as follows:

The tax law . . . requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is

³⁸ See, e.g., *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff’d* 73 T.C.M. (CCH) 2189 (1997), *cert. denied* 526 U.S. 1017 (1999).

³⁹ Closely related doctrines also applied by the courts (sometimes interchangeable with the economic substance doctrine) include the “sham transaction doctrine” and the “business purpose doctrine”. See, e.g., *Knetsch v. U.S.*, 364 U.S. 361 (1960) (denying interest deductions on a “sham transaction” whose only purpose was to create the deductions).

warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.⁴⁰

A court decision often credited for laying the foundation of the economic substance doctrine is the Second Circuit decision in *Gregory v. Helvering*.⁴¹ In *Gregory*, a transitory subsidiary was established to effectuate, utilizing the corporate reorganization provisions of the Code, a tax advantaged distribution from a corporation to its shareholder of appreciated corporate securities that the corporation (and its shareholder) intended to sell. Although the tax court found that the transaction satisfied the literal definition of a tax-free reorganization, the Second Circuit held (and the Supreme Court affirmed) that satisfying the literal definition was not enough:

The purpose of the [reorganization] section is plain enough; men engaged in enterprises--industrial, commercial, financial, or any other--might wish to consolidate, or divide, to add to, or subtract from, their holdings . . . But the underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution. To dodge the shareholder's taxes is not one of the transactions contemplated as corporate "reorganizations."⁴²

Business purpose doctrine

Another common law doctrine that overlays and is often considered together with (if not part and parcel of) the economic substance doctrine is the business purpose doctrine. The business purpose test is a subjective inquiry into the motives of the taxpayer -- that is, whether the taxpayer intended the transaction to serve some useful non-tax purpose. In making this determination, some courts have bifurcated a transaction in which independent activities with non-tax objectives have been combined with an unrelated item having only tax-avoidance objectives in order to disallow the tax benefits of the overall transaction.⁴³

Application by the courts

Elements of the doctrine

There is a lack of uniformity regarding the proper application of the economic substance doctrine. Some courts apply a conjunctive test that requires a taxpayer to establish the presence

⁴⁰ *ACM*, 73 T.C.M. at 2215.

⁴¹ 69 F.2d 809 (2nd Cir. 1934), *aff'd* 293 U.S. 465 (1935). The *Gregory* decision also is cited as the seminal case for the substance over form and business purpose doctrines. See, e.g., Department of Treasury, *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals*, at 47, 55 (July 1999).

⁴² *Gregory*, 69 F.2d at 811.

⁴³ *ACM*, 157 F.3d at 256 n.48.

of both economic substance (i.e., the objective component) and business purpose (i.e., the subjective component) in order for the transaction to sustain court scrutiny.⁴⁴ A narrower approach used by some courts is to invoke the economic substance doctrine only after a determination that the transaction lacks both a business purpose and economic substance (i.e., the existence of either a business purpose or economic substance would be sufficient to respect the transaction).⁴⁵ A third approach regards economic substance and business purpose as “simply more precise factors to consider” in determining whether a transaction has any practical economic effects other than the creation of tax benefits.⁴⁶

Profit potential

There also is a lack of uniformity regarding the necessity and level of profit potential necessary to establish economic substance. Since the time of *Gregory*, several courts have denied tax benefits on the grounds that the subject transactions lacked profit potential.⁴⁷ In

⁴⁴ See, e.g., *Pasternak v. Commissioner*, 990 F.2d 893, 898 (6th Cir. 1993) (“The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction.”)

⁴⁵ See, e.g., *Rice’s Toyota World v. Commissioner*, 752 F.2d 89, 91-92 (4th Cir. 1985) (“To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and, second, that the transaction has no economic substance because no reasonable possibility of a profit exists.”); *IES Industries v. U.S.*, 253 F.3d 350, 358 (8th Cir. 2001) (“In determining whether a transaction is a sham for tax purposes [under the Eighth Circuit test], a transaction will be characterized as a sham if it is not motivated by any economic purpose out of tax considerations (the business purpose test), and if it is without economic substance because no real potential for profit exists” (the economic substance test).”) As noted earlier, the economic substance doctrine and the sham transaction doctrine are similar and sometimes are applied interchangeably. For a more detailed discussion of the sham transaction doctrine, see, e.g., Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (including Provisions Relating to Corporate Tax Shelters)* (JCS-3-99) at 182.

⁴⁶ See, e.g., *ACM*, 157 F.3d at 247; *James v. Commissioner*, 899 F.2d 905, 908 (10th Cir. 1995); *Sacks v. Commissioner*, 69 F.3d 982, 985 (9th Cir. 1995) (“Instead, the consideration of business purpose and economic substance are simply more precise factors to consider . . . We have repeatedly and carefully noted that this formulation cannot be used as a ‘rigid two-step analysis’.”).

⁴⁷ See, e.g., *Knetsch*, 364 U.S. at 361; *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966) (holding that an unprofitable, leveraged acquisition of Treasury bills, and accompanying prepaid interest deduction, lacked economic substance); *Ginsburg v. Commissioner*, 35 T.C.M. (CCH) 860 (1976) (holding that a leveraged cattle-breeding program lacked economic substance).

addition, some courts have applied the economic substance doctrine to disallow tax benefits in transactions in which a taxpayer was exposed to risk and the transaction had a profit potential, but the court concluded that the economic risks and profit potential were insignificant when compared to the tax benefits.⁴⁸ Under this analysis, the taxpayer's profit potential must be more than nominal. Conversely, other courts view the application of the economic substance doctrine as requiring an objective determination of whether a "reasonable possibility of profit" from the transaction existed apart from the tax benefits.⁴⁹ In these cases, in assessing whether a reasonable possibility of profit exists, it is sufficient if there is a nominal amount of pre-tax profit as measured against expected net tax benefits.

Description of Proposal

In general

The proposal clarifies and enhances the application of the economic substance doctrine. The proposal provides that a transaction has economic substance (and thus satisfies the economic substance doctrine) only if the taxpayer establishes that (1) the transaction changes in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and (2) the taxpayer has a substantial non-tax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose.

Conjunctive analysis

The proposal clarifies that the economic substance doctrine involves a conjunctive analysis -- there must be an objective inquiry regarding the effects of the transaction on the taxpayer's economic position, as well as a subjective inquiry regarding the taxpayer's motives for engaging in the transaction. Under the proposal, a transaction must satisfy both tests -- i.e., it must change in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and the taxpayer must have a substantial non-tax purpose for entering into such transaction (and the transaction is a reasonable means of accomplishing such purpose) -- in order to satisfy the economic substance doctrine. This clarification eliminates the disparity that exists among the circuits regarding the application of the doctrine, and modifies its application in

⁴⁸ See, e.g., *Goldstein*, 364 F.2d at 739-40 (disallowing deduction even though taxpayer had a possibility of small gain or loss by owning Treasury bills); *Sheldon v. Commissioner*, 94 T.C. 738, 768 (1990) (stating, "potential for gain . . . is infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions").

⁴⁹ See, e.g., *Rice's Toyota World*, 752 F.2d at 94 (the economic substance inquiry requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits); *Compaq Computer Corp.*, 277 F.3d at 781 (applied the same test, citing *Rice's Toyota World*); *IES Industries*, 253 F.3d at 354 (the application of the objective economic substance test involves determining whether there was a "reasonable possibility of profit . . . apart from tax benefits.").

those circuits in which either a change in economic position or a non-tax business purpose (without having both) is sufficient to satisfy the economic substance doctrine.⁵⁰

Non-tax business purpose

The proposal provides that a taxpayer's non-tax purpose for entering into a transaction (the second prong in the analysis) must be "substantial," and that the transaction must be "a reasonable means" of accomplishing such purpose. Under this formulation, the non-tax purpose for the transaction must bear a reasonable relationship to the taxpayer's normal business operations or investment activities.⁵¹

In determining whether a taxpayer has a substantial non-tax business purpose, it is intended that an objective of achieving a favorable accounting treatment for financial reporting purposes will not be treated as having a substantial non-tax purpose.⁵² Furthermore, a transaction that is expected to increase financial accounting income as a result of generating tax deductions or losses without a corresponding financial accounting charge (i.e., a permanent book-tax difference)⁵³ should not be considered to have a substantial non-tax purpose unless a substantial non-tax purpose exists apart from the financial accounting benefits.⁵⁴

⁵⁰ Cf., e.g., *Boca Investering Partnership v. U.S.*, 167 F. Supp. 2d 298, 376-77 (D.D.C. 2001) (in determining whether the transaction in question should be respected under the economic substance doctrine, the test in the D.C. Circuit requires a transaction to be respected under the doctrine unless it lacks both a valid non-tax business purpose and a reasonable possibility of profit).

⁵¹ See, Martin McMahon Jr., *Economic Substance, Purposive Activity, and Corporate Tax Shelters*, 94 Tax Notes 1017, 1023 (Feb. 25, 2002) (advocates "confining the most rigorous application of business purpose, economic substance, and purposive activity tests to transactions outside the ordinary course of the taxpayer's business -- those transactions that do not appear to contribute to any business activity or objective that the taxpayer may have had apart from tax planning but are merely loss generators."); Mark P. Gergen, *The Common Knowledge of Tax Abuse*, 54 SMU L. Rev. 131, 140 (Winter 2001) ("The message is that you can pick up tax gold if you find it in the street while going about your business, but you cannot go hunting for it.").

⁵² However, if the tax benefits are clearly contemplated and expected by the language and purpose of the relevant authority, such tax benefits should not be disallowed solely because the transaction results in a favorable accounting treatment. An example is the repealed foreign sales corporation rules.

⁵³ This includes tax deductions or losses that are anticipated to be recognized in a period subsequent to the period the financial accounting benefit is recognized. For example, FAS 109 in some cases permits the recognition of financial accounting benefits prior to the period in which the tax benefits are recognized for income tax purposes.

⁵⁴ Claiming that a financial accounting benefit constitutes a substantial non-tax purpose fails to consider the origin of the accounting benefit (i.e., reduction of taxes) and significantly diminishes the purpose for having a substantial non-tax purpose requirement. See, e.g.,

By requiring that a transaction be a “reasonable means” of accomplishing its non-tax purpose, the proposal broadens the ability of the courts to bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow the tax benefits of the overall transaction.

Profit potential

Under the proposal, a taxpayer may rely on factors other than profit potential to demonstrate that a transaction results in a meaningful change in the taxpayer’s economic position; the proposal merely sets forth a minimum threshold of profit potential if that test is relied on to demonstrate a meaningful change in economic position. Specifically, if a taxpayer relies on a profit potential, the present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.⁵⁵ Moreover, the profit potential must exceed a risk-free rate of return. In addition, in determining pre-tax profit, fees and other transaction expenses and foreign taxes are treated as expenses.

In applying the profit test to the lessor of tangible property, depreciation and other applicable tax credits (such as the rehabilitation tax credit and the low income housing tax credit) are not taken into account in measuring tax benefits. Thus, a traditional leveraged lease is not affected by the bill to the extent it meets the present law standards.

Transactions with tax-indifferent parties

The proposal also provides special rules for transactions with tax-indifferent parties. For this purpose, a tax-indifferent party means any person or entity not subject to Federal income tax, or any person to whom an item would have no substantial impact on its income tax liability. Under these rules, the form of a financing transaction will not be respected if the present value of the tax deductions to be claimed is substantially in excess of the present value of the anticipated economic returns to the lender. Also, the form of a transaction with a tax-indifferent party will not be respected if it results in an allocation of income or gain to the tax-indifferent party in excess of the tax-indifferent party’s economic gain or income or if the transaction results in the shifting of basis on account of overstating the income or gain of the tax-indifferent party.

American Electric Power, Inc. v. U.S., 136 F. Supp. 2d 762, 791-92 (S.D. Ohio, 2001) (“AEP’s intended use of the cash flows generated by the [corporate-owned life insurance] plan is irrelevant to the subjective prong of the economic substance analysis. If a legitimate business purpose for the use of the tax savings ‘were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, [then] every sham tax-shelter device might succeed,’” citing *Winn-Dixie v. Commissioner*, 113 T.C. 254, 287 (1999)).

⁵⁵ Thus, a “reasonable possibility of profit” will not be sufficient to establish that a transaction has economic substance.

Other rules

The Secretary may prescribe regulations which provide (1) exemptions from the application of this proposal, and (2) other rules as may be necessary or appropriate to carry out the purposes of the proposal.

No inference is intended as to the proper application of the economic substance doctrine under present law. In addition, except with respect to the economic substance doctrine, the proposal shall not be construed as altering or supplanting any other common law doctrine (including the sham transaction doctrine), and this proposal shall be construed as being additive to any such other doctrine.

Effective Date

The proposal applies to transactions entered into after the date of enactment.

2. Penalty for failure to disclose reportable transactions

Present Law

Regulations under section 6011 require a taxpayer to disclose with its tax return certain information with respect to each “reportable transaction” in which the taxpayer participates.⁵⁶

There are two categories of reportable transactions. The first category includes any transaction that is the same as (or substantially similar to)⁵⁷ a transaction that is specified by the Treasury Department as a tax avoidance transaction whose tax benefits are subject to disallowance under present law (referred to as a “listed transaction”).

The second category of reportable transactions includes transactions that are expected to reduce a taxpayer’s Federal income tax liability by more than \$5 million in any single year or \$10 million in any combination of years and that have at least two of the following characteristics: (1) the taxpayer has participated in the transaction under conditions of confidentiality; (2) the taxpayer has obtained or been provided with contractual protection against the possibility that part or all of the intended tax benefits from the transaction will not be sustained; (3) the promoters of the transaction have received or are expected to receive fees or

⁵⁶ Temp. Treas. Reg. sec. 1.6011-4T; Prop. Treas. Reg. sec. 1.6011-4. Effective June 14, 2002, the regulations were modified to require non-corporate taxpayers (i.e., individuals, trusts, partnerships, and S corporations) to disclose their participation in reportable transactions that have been specified by the Treasury Department as “listed” transactions. *See* T.D. 9000, 67 Fed. Reg. 41,324 (June 18, 2002). Disclosure of other reportable transactions under the regulations continues to be limited to corporate taxpayers.

⁵⁷ The recently-modified regulations clarify that the term “substantially similar” includes any transaction that is expected to obtain the same or similar types of tax benefits and that is either factually similar or based on the same or similar tax strategy. Also, the term must be broadly construed in favor of disclosure. *See* T.D. 9000, 67 Fed. Reg. 41,324 (June 18, 2002).

other consideration with an aggregate value in excess of \$100,000, and such fees are contingent on the taxpayer's participation; (4) the transaction results in a reported book/tax difference in excess of \$5 million in any taxable year; or (5) the transaction involves a person that the taxpayer knows or has reason to know is in a Federal income tax position that differs from that of the taxpayer (such as a tax-exempt entity or foreign person), and the taxpayer knows or has reason to know that such difference has permitted the transaction to be structured to provide the taxpayer with a more favorable Federal income tax treatment.⁵⁸

Under present law, there is no specific penalty for failing to disclose a reportable transaction; however, such a failure may jeopardize a taxpayer's ability to claim that any income tax understatement attributable to such undisclosed transaction is due to reasonable cause, and that the taxpayer acted in good faith.⁵⁹

Description of Proposal

In general

The proposal creates a new penalty for any person who fails to include with any return or statement any required information with respect to a reportable transaction. The new penalty applies without regard to whether the transaction ultimately results in an understatement of tax, and applies in addition to any accuracy-related penalty that may be imposed.

Transactions to be disclosed

The proposal does not define the terms "listed transaction"⁶⁰ or "reportable transaction," nor does the proposal explain the type of information that must be disclosed in order to avoid the imposition of a penalty. Rather, the proposal authorizes the Treasury Department to define a "listed transaction" and a "reportable transaction" under section 6011. It is expected that the Treasury Department will issue new regulations under section 6011 that will provide taxpayers with a set of objective standards to be applied in determining whether a taxpayer must disclose information regarding a particular transaction. The new regulations are expected to define a reportable transaction to include (but not be limited to) transactions with any of the following

⁵⁸ Temp. Treas. Reg. sec. 1.6011-4T(b)(3)(i)(A)-(E). In certain circumstances, a taxpayer can avoid disclosure with respect to the second category of reportable transactions. *See* Temp. Treas. Reg. sec. 1.6011-4T(b)(3)(ii)(A)-(E).

⁵⁹ Section 6664(c) provides that a taxpayer can avoid the imposition of a section 6662 accuracy-related penalty in cases where the taxpayer can demonstrate that there was reasonable cause for the underpayment and that the taxpayer acted in good faith.

⁶⁰ The proposal states that, except as provided in regulations, a listed transaction means a reportable transaction, which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011. For this purpose, it is expected that the definition of "substantially similar" will be the same as the one used in Temp. Treas. Reg. 1.6011-4T(b)(i). However, the Secretary may modify this definition (as well as the definitions of "listed transaction" and "reportable transactions") as appropriate.

characteristics: (1) a significant loss, (2) a brief holding period, (3) a transaction that is marketed under conditions of confidentiality, (4) a transaction that is subject to indemnification agreements, or (5) a certain amount of book-tax difference.⁶¹

Disclosure requirements

It is expected that the new regulations will specify the manner in which a taxpayer must disclose reportable transactions. The information required to be disclosed with respect to reportable transactions should be sufficiently detailed so as to provide the Treasury Department and IRS the ability to analyze all aspects of the transaction and determine an appropriate course of action (if any). To accomplish this objective, a taxpayer may be required to disclose the following information with respect to a reportable transaction: (1) a detailed description of all facts relevant to the expected tax treatment of the reportable transaction (such as the structure of the transaction and the principal elements of the transaction), (2) a description and schedule of the expected tax benefits for all tax years resulting from the reportable transaction (including any anticipated transactions as part of the overall strategy), (3) if applicable, the names and addresses of any party who promoted, solicited, or recommended the taxpayer's participation in the transaction and who had a financial interest (including the receipt of fees) in the taxpayer's decision to participate, and (4) other information that the Secretary may prescribe (e.g., the involvement of any accommodation party or any tax-indifferent party, the receipt of a tax opinion with respect to the transaction, the amount of any fees paid to any promoter or advisor in connection with the transaction, any anticipated subsequent transactions or exit strategies).

It is intended that, in accordance with section 6065 (relating to verification of returns), the form the Secretary prescribes for taxpayer disclosure of reportable transactions will include a written declaration that the information is being provided under penalties of perjury. Moreover, the verification under penalties of perjury also should apply to any large entity that discloses that it did not enter into any reportable transactions during the tax year covered by such declaration.

⁶¹ See generally, "The Treasury Department's Enforcement Proposals for Abusive Tax Avoidance Transactions," released on March 20, 2002, *reprinted electronically* at 2002 TNT 55-28 (March 21, 2002) (the "Treasury shelter initiative"). The Treasury shelter initiative stated that a reportable transaction would be defined as any transaction with any of the following characteristics: (1) any transaction specifically identified by the IRS in published guidance as a tax avoidance transaction without regard to the size of the tax savings (i.e., a "listed transaction"), (2) certain loss transactions under section 165 in excess of \$10 million for corporations, partnerships, and S corporations (\$2 million for trusts and individuals), (3) any transaction resulting in a tax credit in excess of \$250,000 if the taxpayer held the underlying asset for less than 45 days, (4) any book-tax difference of at least \$10 million, subject to certain exceptions, and (5) any transaction marketed under conditions of confidentiality, if the transaction is expected to result in a reduction in taxable income of at least \$250,000 (\$500,000 in the case of a corporation).

Penalty rate

The penalty for failing to disclose a reportable transaction is \$50,000. The amount is increased to \$100,000 if the failure is with respect to a listed transaction. For large entities and high net worth individuals, the penalty amount is doubled (i.e., \$100,000 for a reportable transaction and \$200,000 for a listed transaction). The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the penalty can be rescinded or abated only in exceptional circumstances.⁶² All or part of the penalty may be rescinded only if: (1) the taxpayer on whom the penalty is imposed has a history of complying with the Federal tax laws, (2) it is shown that the violation is due to an unintentional mistake of fact, (3) imposing the penalty would be against equity and good conscience, and (4) rescinding the penalty would promote compliance with the tax laws and effective tax administration. The authority to rescind the penalty can only be exercised by the IRS Commissioner personally or the head of the Office of Tax Shelter Analysis; this authority to rescind cannot otherwise be delegated by the Commissioner. Thus, the penalty cannot be rescinded by a revenue agent, an appeals officer, or any other IRS personnel. The decision to rescind a penalty must be accompanied by a record describing the facts and reasons for the action and the amount rescinded. There will be no taxpayer right to appeal a refusal to rescind a penalty. The IRS also is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this proposal and the reasons for the rescission.

A “large entity” is defined as any entity with gross receipts in excess of \$10 million in the year of the transaction or in the preceding year. A “high net worth individual” is defined as any individual whose net worth exceeds \$2 million, based on the fair market value of the individual’s assets and liabilities immediately before entering into the transaction.

A public entity that is required to pay a penalty for failing to disclose a listed transaction (or is subject to an understatement penalty attributable to a non-disclosed listed transaction, a non-disclosed reportable avoidance transaction, or a transaction that lacks economic substance⁶³) must disclose the imposition of the penalty in reports to the Securities and Exchange Commission (“SEC”) for such period as the Secretary shall specify. The proposal applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and treats any failure to disclose a transaction in such reports as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the SEC once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).

⁶² The Secretary’s present-law authority to postpone certain tax-related deadlines because of Presidentially-declared disasters (sec. 7508A) will also encompass the authority to postpone the reporting deadlines established by the proposal.

⁶³ These categories of transactions are described in greater detail below in connection with the proposals modifying the accuracy-related penalty for listed and certain reportable transactions and a penalty for understatements attributable to transactions that lack economic substance.

As described above in connection with present law, current regulations under section 6011 require the disclosure of certain reportable transactions. Until such regulations are modified to reflect the new categories of reportable transactions, the penalty will apply to taxpayers who fail to timely disclose any reportable transaction under the definitions contained in the current regulations.

Effective Date

The proposal is effective for returns and statements the due date for which is after the date of enactment.

3. Modifications to the accuracy-related penalties for listed transactions and reportable transactions having a significant tax avoidance purpose

Present Law

The accuracy-related penalty applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or \$5,000 (\$10,000 in the case of corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.⁶⁴ The amount of any understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.⁶⁵

Special rules apply with respect to tax shelters.⁶⁶ For understatements by non-corporate taxpayers attributable to tax shelters, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters.

The understatement penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was “reasonable cause” for the underpayment and that the taxpayer acted in good faith.⁶⁷ The relevant regulations provide that reasonable cause exists where the taxpayer “reasonably relies in good faith on an opinion based on a professional tax advisor’s analysis of the pertinent facts and authorities [that] . . . unambiguously

⁶⁴ Sec. 6662.

⁶⁵ Sec. 6662(d)(2)(B).

⁶⁶ Sec. 6662(d)(2)(C).

⁶⁷ Sec. 6664(c).

concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged” by the IRS.⁶⁸

Description of Proposal

In general

The proposal modifies the present-law accuracy related penalty by replacing the rules applicable to tax shelters with a new accuracy-related penalty that applies to listed transactions and reportable transactions with a significant tax avoidance purpose (hereinafter referred to as a “reportable avoidance transaction”).⁶⁹ The penalty rate and defenses available to avoid the penalty vary depending on the category of the transaction (i.e., listed or reportable avoidance transaction) and whether the transaction was adequately disclosed.

Disclosed transactions

In general, a 20-percent accuracy-related penalty is imposed on any understatement attributable to an adequately disclosed listed transaction or reportable avoidance transaction. The only exception to the penalty is if the taxpayer satisfies a more stringent reasonable cause and good faith exception (hereinafter referred to as the “strengthened reasonable cause exception”), which is described below. The strengthened reasonable cause exception is available only if the relevant facts affecting the tax treatment are adequately disclosed, there is or was substantial authority for the claimed tax treatment, and the taxpayer reasonably believed that the claimed tax treatment was more likely than not the proper treatment.

Undisclosed transactions

If the taxpayer does not adequately disclose the transaction, the strengthened reasonable cause exception is not available (i.e., a strict-liability penalty applies), and the taxpayer is subject to an increased penalty rate equal to 30 percent of the understatement.

In addition, a public entity that is required to pay the 30 percent penalty must disclose the imposition of the penalty in reports to the SEC for such periods as the Secretary shall specify. The disclosure to the SEC applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and any failure to disclose such penalty in the reports is treated as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the SEC once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).

Once the 30 percent penalty has been included in the Revenue Agent Report, the penalty cannot be compromised for purposes of a settlement without approval of the Commissioner

⁶⁸ Treas. Reg. sec. 1.6662-4(g)(4)(i)(B); Treas. Reg. sec. 1.6664-4(c).

⁶⁹ The terms “reportable transaction” and “listed transaction” have the same meanings as previously described in connection with the penalty for failing to disclose reportable transactions.

personally or the head of the Office of Tax Shelter Analysis. Furthermore, the IRS is required to submit an annual report to Congress summarizing the application of this penalty and providing a description of each penalty compromised under this proposal and the reasons for the compromise.

Determination of the understatement amount

The penalty is applied to the amount of any understatement attributable to the listed or reportable avoidance transaction without regard to other items on the tax return. For purposes of this proposal, the amount of the understatement is determined as the sum of (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return)⁷⁰, and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item.

Except as provided in regulations, a taxpayer's treatment of an item shall not take into account any amendment or supplement to a return if the amendment or supplement is filed after the earlier of when the taxpayer is first contacted regarding an examination of the return or such other date as specified by the Secretary.

Strengthened reasonable cause exception

A penalty is not imposed under the proposal with respect to any portion of an understatement if it shown that there was reasonable cause for such portion and the taxpayer acted in good faith. Such a showing requires (1) adequate disclosure of the facts affecting the transaction in accordance with the regulations under section 6011,⁷¹ (2) there is or was substantial authority for such treatment, and (3) the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. For this purpose, a taxpayer will be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief (1) is based on the facts and law that exist at the time the tax return (that includes the item) is filed, and (2) relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that (a) a return will not be audited, (b) the treatment will not be raised on audit, or (c) the treatment will be resolved through settlement if raised.

A taxpayer may (but is not required to) rely on an opinion of a tax advisor in establishing its reasonable belief with respect to the tax treatment of the item. However, a taxpayer may not rely on an opinion of a tax advisor for this purpose if the opinion (1) is provided by a "disqualified tax advisor," or (2) is a "disqualified opinion."

⁷⁰ For this purpose, any reduction in the excess of deductions allowed for the taxable year over gross income for such year, and any reduction in the amount of capital losses which would (without regard to section 1211) be allowed for such year, shall be treated as an increase in taxable income.

⁷¹ See the previous discussion regarding the penalty for failing to disclose a reportable transaction.

Disqualified tax advisor

A disqualified tax advisor is any advisor who (1) is a material advisor⁷² and who participates in the organization, management, promotion or sale of the transaction or is related (within the meaning of section 267 or 707) to any person who so participates, (2) is compensated directly or indirectly⁷³ by a material advisor with respect to the transaction, (3) has a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax benefits from the transaction being sustained, or (4) as determined under regulations prescribed by the Secretary, has a continuing financial interest with respect to the transaction.

Organization, management, promotion or sale of a transaction

A material advisor is considered as participating in the “organization” of a transaction if the advisor performs acts relating to the development of the transaction. This may include, for example, preparing documents (1) establishing a structure used in connection with the transaction (such as a partnership agreement), (2) describing the transaction (such as an offering memorandum or other statement describing the transaction), or (3) relating to the registration of the transaction with any federal, state or local government body.⁷⁴ Participation in the “management” of a transaction means involvement in the decision-making process regarding any business activity with respect to the transaction. Participation in the “promotion or sale” of a transaction means involvement in the marketing or solicitation of the transaction to others. Thus, an advisor who provides information about the transaction to a potential participant is involved in the promotion or sale of a transaction, as is any advisor who recommends the transaction to a potential participant.

⁷² The term “material advisor” (defined below in connection with the new information filing requirements for material advisors) means any person who provides any material aid, assistance, or advice with respect to organizing, promoting, selling, implementing, or carrying out any reportable transaction, and who derives gross income in excess of \$50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons (\$250,000 in any other case).

⁷³ This situation could arise, for example, when an advisor has an arrangement or understanding (oral or written) with an organizer, manager, or promoter of a reportable transaction that such party will recommend or refer potential participants to the advisor for an opinion regarding the tax treatment of the transaction.

⁷⁴ An advisor should not be treated as participating in the organization of a transaction if the advisor’s only involvement with respect to the organization of the transaction is the rendering of an opinion regarding the tax consequences of such transaction. However, such an advisor may be a “disqualified tax advisor” with respect to the transaction if the advisor participates in the management, promotion or sale of the transaction (or if the advisor is compensated by a material advisor, has a fee arrangement that is contingent on the tax benefits of the transaction, or as determined by the Secretary, has a continuing financial interest with respect to the transaction).

Disqualified opinion

An opinion may not be relied upon if the opinion (1) is based on unreasonable factual or legal assumptions (including assumptions as to future events), (2) unreasonably relies upon representations, statements, findings or agreements of the taxpayer or any other person, (3) does not identify and consider all relevant facts, or (4) fails to meet any other requirement prescribed by the Secretary.

Coordination with other penalties

Any understatement to which a penalty is imposed under this proposal is not subject to the accuracy-related penalty under section 6662. However, such understatement is included for purposes of determining whether any understatement (as defined in sec. 6662(d)(2)) is a substantial understatement as defined under section 6662(d)(1).

The penalty imposed under this proposal shall not apply to any portion of an understatement to which a fraud penalty is applied under section 6663.

Effective Date

The proposal is effective for taxable years ending after the date of enactment.

4. Penalty for understatements from transactions lacking economic substance

Present Law

An accuracy-related penalty applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or \$5,000 (\$10,000 in the case of corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.⁷⁵ The amount of any understatement is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.

Special rules apply with respect to tax shelters.⁷⁶ For understatements by non-corporate taxpayers attributable to tax shelters, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters.

⁷⁵ Sec. 6662.

⁷⁶ Sec. 6662(d)(2)(C).

The penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was “reasonable cause” for the underpayment and that the taxpayer acted in good faith.⁷⁷ The relevant regulations provide that reasonable cause exists where the taxpayer “reasonably relies in good faith on an opinion based on a professional tax advisor’s analysis of the pertinent facts and authorities [that] . . . unambiguously concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged” by the IRS.⁷⁸

Description of Proposal

The proposal imposes a penalty for an understatement attributable to any transaction that lacks economic substance (referred to in the statute as a “non-economic substance transaction understatement”).⁷⁹ The penalty rate is 40 percent (reduced to 20 percent if the taxpayer adequately discloses the relevant facts in accordance with regulations prescribed under section 6011). No exceptions (including the reasonable cause or rescission rules) to the penalty would be available under the proposal (i.e., the penalty is a strict-liability penalty).

A “non-economic substance transaction” means any transaction if (1) the transaction lacks economic substance (as defined in the earlier proposal regarding the economic substance doctrine),⁸⁰ (2) the transaction was not respected under the rules relating to transactions with tax-indifferent parties (as described in the earlier proposal regarding the economic substance doctrine),⁸¹ or (3) any similar rule of law. For this purpose, a similar rule of law would include, for example, an understatement attributable to a transaction that is determined to be a sham transaction.

For purposes of this proposal, the calculation of an “understatement” is made in the same manner as in the separate proposal relating to accuracy-related penalties for listed and reportable avoidance transactions (new sec. 6662A). Thus, the amount of the understatement under this proposal would be determined as the sum of (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer’s treatment of the item and the proper treatment of the item (without regard to other

⁷⁷ Sec. 6664(c).

⁷⁸ Treas. Reg. sec. 1.6662-4(g)(4)(i)(B); Treas. Reg. sec. 1.6664-4(c).

⁷⁹ Thus, unlike the new accuracy-related penalty under section 6662A (which applies only to listed and reportable avoidance transactions), the new penalty under this proposal applies to any transaction that lacks economic substance.

⁸⁰ The proposal provides that a transaction has economic substance only if (1) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position, and (2) the transaction has a substantial non-tax purpose for entering into such transaction and is a reasonable means of accomplishing such purpose.

⁸¹ The proposal provides that the form of a transaction that involves a tax-indifferent party will not be respected in certain circumstances.

items on the tax return),⁸² and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item. In essence, the penalty will apply to the amount of any understatement attributable solely to a non-economic substance transaction.

Except as provided in regulations, the taxpayer's treatment of an item will not take into account any amendment or supplement to a return if the amendment or supplement is filed after the earlier of the date the taxpayer is first contacted regarding an examination of the return or such other date as specified by the Secretary.

A public entity that is required to pay a penalty under this proposal (regardless of whether the transaction was disclosed) must disclose the imposition of the penalty in reports to the SEC for such periods as the Secretary shall specify. The disclosure to the SEC applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and any failure to disclose such penalty in the reports is treated as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the SEC once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).

Once a penalty (regardless of whether the transaction was disclosed) has been included in the Revenue Agent Report, the penalty cannot be compromised for purposes of a settlement without approval of the Commissioner personally or the head of the Office of Tax Shelter Analysis. Furthermore, the IRS is required to submit an annual report to Congress summarizing the application of this penalty and providing a description of each penalty compromised under this proposal and the reasons for the compromise.

Any understatement to which a penalty is imposed under this proposal will not be subject to the accuracy-related penalty under section 6662 or under new 6662A (accuracy-related penalties for listed and reportable avoidance transactions). However, an understatement under this proposal would be taken into account for purposes of determining whether any understatement (as defined in sec. 6662(d)(2)) is a substantial understatement as defined under section 6662(d)(1). The penalty imposed under this proposal will not apply to any portion of an understatement to which a fraud penalty is applied under section 6663.

Effective Date

The proposal applies to transactions after the date of enactment.

⁸² For this purpose, any reduction in the excess of deductions allowed for the taxable year over gross income for such year, and any reduction in the amount of capital losses that would (without regard to section 1211) be allowed for such year, would be treated as an increase in taxable income.

5. Modifications to the substantial understatement penalty

Present Law

Definition of substantial understatement

An accuracy-related penalty equal to 20 percent applies to any substantial understatement of tax. A “substantial understatement” exists if the correct income tax liability for a taxable year exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or \$5,000 (\$10,000 in the case of most corporations).⁸³

Reduction of understatement for certain positions

For purposes of determining whether a substantial understatement penalty applies, the amount of any understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.⁸⁴

The Secretary is required to publish annually in the Federal Register a list of positions for which the Secretary believes there is not substantial authority and which affect a significant number of taxpayers.⁸⁵

Description of Proposal

Definition of substantial understatement

The proposal modifies the definition of “substantial” for corporate taxpayers. Under the proposal, a corporate taxpayer has a substantial understatement if the amount of the understatement for the taxable year exceeds the lesser of (1) 10 percent of the tax required to be shown on the return for the taxable year (or, if greater, \$10,000), or (2) \$10 million.

Reduction of understatement for certain positions

The proposal elevates the standard that a taxpayer must satisfy in order to reduce the amount of an understatement for undisclosed items. With respect to the treatment of an item whose facts are not adequately disclosed, a resulting understatement is reduced only if the taxpayer had a reasonable belief that the tax treatment was more likely than not the proper treatment. The proposal also authorizes (but does not require) the Secretary to publish a list of positions for which it believes there is not substantial authority or there is no reasonable belief that the tax treatment is more likely than not the proper treatment (without regard to whether

⁸³ Sec. 6662(a) and (d)(1)(A).

⁸⁴ Sec. 6662(d)(2)(B).

⁸⁵ Sec. 6662(d)(2)(D).

such positions affect a significant number of taxpayers). The list shall be published in the Federal Register or the Internal Revenue Bulletin.

Effective Date

The proposal is effective for taxable years beginning after date of enactment.

6. Tax shelter exception to confidentiality privileges relating to taxpayer communications

Present Law

In general, a common law privilege of confidentiality exists for communications between an attorney and client with respect to the legal advice the attorney gives the client. The Code provides that, with respect to tax advice, the same common law protections of confidentiality that apply to a communication between a taxpayer and an attorney also apply to a communication between a taxpayer and a federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney. This rule is inapplicable to communications regarding corporate tax shelters.

Description of Proposal

The proposal modifies the rule relating to corporate tax shelters by making it applicable to all tax shelters, whether entered into by corporations, individuals, partnerships, tax-exempt entities, or any other entity. Accordingly, communications with respect to tax shelters are not subject to the confidentiality proposal of the Code that otherwise applies to a communication between a taxpayer and a federally authorized tax practitioner.

Effective Date

The proposal is effective with respect to communications made on or after the date of enactment.

7. Disclosure of reportable transactions by material advisors

Present Law

Registration of tax shelter arrangements

An organizer of a tax shelter is required to register the shelter with the Secretary not later than the day on which the shelter is first offered for sale.⁸⁶ A “tax shelter” means any investment with respect to which the tax shelter ratio⁸⁷ for any investor as of the close of any of the first five

⁸⁶ Sec. 6111(a).

⁸⁷ The tax shelter ratio is, with respect to any year, the ratio that the aggregate amount of the deductions and 350 percent of the credits, which are represented to be potentially allowable to any investor, bears to the investment base (money plus basis of assets contributed) as of the close of the tax year.

years ending after the investment is offered for sale may be greater than two to one and which is: (1) required to be registered under Federal or State securities laws, (2) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or State securities agency, or (3) a substantial investment (greater than \$250,000 and at least five investors).⁸⁸

Other promoted arrangements are treated as tax shelters for purposes of the registration requirement if: (1) a significant purpose of the arrangement is the avoidance or evasion of Federal income tax by a corporate participant; (2) the arrangement is offered under conditions of confidentiality; and (3) the promoter may receive fees in excess of \$100,000 in the aggregate.⁸⁹

A transaction has a “significant purpose of avoiding or evading Federal income tax” if the transaction: (1) is the same as or substantially similar to a “listed transaction,”⁹⁰ or (2) is structured to produce tax benefits that constitute an important part of the intended results of the arrangement and the promoter reasonably expects to present the arrangement to more than one taxpayer.⁹¹ Certain exceptions are provided with respect to the second category of transactions.⁹²

An arrangement is offered under conditions of confidentiality if: (1) an offeree has an understanding or agreement to limit the disclosure of the transaction or any significant tax features of the transaction; or (2) the promoter claims, knows, or has reason to know that a party other than the potential participant claims that the transaction (or any aspect of it) is proprietary to the promoter or any party other than the offeree, or is otherwise protected from disclosure or use.⁹³

Failure to register tax shelter

The penalty for failing to timely register a tax shelter (or for filing false or incomplete information with respect to the tax shelter registration) generally is the greater of one percent of the aggregate amount invested in the shelter or \$500.⁹⁴ However, if the tax shelter involves an

⁸⁸ Sec. 6111(c).

⁸⁹ Sec. 6111(d).

⁹⁰ Temp. Treas. Reg. sec. 301.6111-2T(b)(2).

⁹¹ Temp. Treas. Reg. sec. 301.6111-2T(b)(3).

⁹² Temp. Treas. Reg. sec. 301.6111-2T(b)(4).

⁹³ The regulations provide that the determination of whether an arrangement is offered under conditions of confidentiality is based on all the facts and circumstances surrounding the offer. If an offeree’s disclosure of the structure or tax aspects of the transaction are limited in any way by an express or implied understanding or agreement with or for the benefit of a tax shelter promoter, an offer is considered made under conditions of confidentiality, whether or not such understanding or agreement is legally binding. Treas. Reg. sec. 301.6111-2T(c)(1).

⁹⁴ Sec. 6707.

arrangement offered to a corporation under conditions of confidentiality, the penalty is the greater of \$10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration. Intentional disregard of the requirement to register increases the penalty to 75 percent of the applicable fees.

Section 6707 also imposes (1) a \$100 penalty on the promoter for each failure to furnish the investor with the required tax shelter identification number, and (2) a \$250 penalty on the investor for each failure to include the tax shelter identification number on a return.

Description of Proposal

Disclosure of reportable transactions by material advisors

The proposal repeals the present law rules with respect to registration of tax shelters. Instead, the proposal requires each material advisor with respect to any reportable transaction (including listed transaction)⁹⁵ to timely file an information return with the Secretary (in such form and manner as the Secretary may prescribe). The return must be filed on such date as specified by the Secretary.

The information return will include (1) information identifying and describing the transaction, (2) information describing any potential tax benefits expected to result from the transaction, and (3) such other information as the Secretary may prescribe. It is expected that the Secretary may seek from the material advisor the same type of information that the Secretary may request from a taxpayer in connection with a reportable transaction.⁹⁶

A “material advisor” means any person (1) who provides material aid, assistance, or advice with respect to organizing, promoting, selling, implementing, or carrying out any reportable transaction, and (2) who directly or indirectly derives gross income in excess of \$250,000 (\$50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons) for such advice or assistance.

The Secretary may prescribe regulations which provide (1) that only one material advisor has to file an information return in cases in which two or more material advisors would otherwise be required to file information returns with respect to a particular reportable transaction, (2) exemptions from the requirements of this section, and (3) other rules as may be necessary or appropriate to carry out the purposes of this section (including, for example, rules regarding the aggregation of fees in appropriate circumstances).

⁹⁵ The terms “reportable transaction” and “listed transaction” have the same meaning as previously described in connection with the taxpayer-related proposals.

⁹⁶ See the previous discussion regarding the disclosure requirements under new section 6707A.

Penalty for failing to furnish information regarding reportable transactions

The proposal repeals the present law penalty for failure to register tax shelters. Instead, the proposal imposes a penalty on any material advisor who fails to file an information return, or who files a false or incomplete information return, with respect to a reportable transaction (including a listed transaction).⁹⁷ The amount of the penalty is \$50,000. If the penalty is with respect to a listed transaction, the amount of the penalty is increased to the greater of (1) \$200,000, or (2) 50 percent of the gross income of such person with respect to aid, assistance, or advice which is provided with respect to the reportable transaction before the date the information return that includes the transaction is filed. Intentional disregard by a material advisor of the requirement to disclose a reportable transaction increases the penalty to 75 percent of the gross income.

The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the penalty can be rescinded or abated only in exceptional circumstances.⁹⁸ All or part of the penalty may be rescinded only if: (1) the material advisor on whom the penalty is imposed has a history of complying with the Federal tax laws, (2) it is shown that the violation is due to an unintentional mistake of fact, (3) imposing the penalty would be against equity and good conscience, and (4) rescinding the penalty would promote compliance with the tax laws and effective tax administration. The authority to rescind the penalty can only be exercised by the Commissioner personally or the head of the Office of Tax Shelter Analysis; this authority to rescind cannot otherwise be delegated by the Commissioner. Thus, the penalty cannot be rescinded by a revenue agent, an appeals officer, or other IRS personnel. The decision to rescind a penalty must be accompanied by a record describing the facts and reasons for the action and the amount rescinded. There will be no right to appeal a refusal to rescind a penalty. The IRS also is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this proposal and the reasons for the rescission.

Effective Date

The proposal requiring disclosure of reportable transactions by material advisors applies to transactions with respect to which material aid, assistance or advice is provided after the date of enactment.

The proposal imposing a penalty for failing to disclose reportable transactions applies to returns the due date for which is after the date of enactment.

⁹⁷ The terms “reportable transaction” and “listed transaction” have the same meaning as previously described in connection with the taxpayer-related proposals.

⁹⁸ The Secretary’s present-law authority to postpone certain tax-related deadlines because of Presidentially-declared disasters (sec. 7508A) will also encompass the authority to postpone the reporting deadlines established by the proposal.

8. Investor lists and modification of penalty for failure to maintain investor lists

Present Law

Investor lists

A promoter must maintain (for a period of seven years) a list identifying each person who was sold an interest in any tax shelter with respect to which registration was required under section 6111 (even though the particular party may not have been subject to confidentiality restrictions).⁹⁹ Regulations under section 6112 provide that, in addition to the name, tax shelter identification number and other identifying information the promoter must include detailed information about the tax shelter (including details of the shelter and the expected tax benefits, as well as copies of any additional written material given to any participant or advisor).¹⁰⁰ A limited exception is provided for certain shelters if the total fees are less than \$25,000 or if the expected reduction in tax liabilities for any single year is less than \$1 million for corporations or \$250,000 for non-corporate taxpayers.¹⁰¹ The Secretary is required to prescribe regulations which provide that, in cases in which 2 or more persons are required to maintain the same list, only one person would be required to maintain the list.¹⁰²

Penalties for failing to maintain investor lists

Under section 6708, the penalty for failing to maintain the list required under section 6112 is \$50 for each name omitted from the list (with a maximum penalty of \$100,000 per year).

Description of Proposal

Investor lists

Each material advisor¹⁰³ that is required to file an information return with respect to a reportable transaction (including a listed transaction)¹⁰⁴ is required to maintain a list that (1) identifies each person with respect to whom the advisor acted as a material advisor with respect to the reportable transaction, and (2) contains other information as may be required by the Secretary. In addition, the proposal authorizes (but does not require) the Secretary to prescribe

⁹⁹ Sec. 6112.

¹⁰⁰ See Temp. Treas. Reg. sec. 301.6112-1T Q&A 17.

¹⁰¹ See Temp. Treas. Reg. sec. 301-6112-1T Q&A 8.

¹⁰² Sec. 6112(c)(2).

¹⁰³ The term “material advisor” has the same meaning as when used in connection with the requirement to file an information return under section 6111.

¹⁰⁴ The terms “reportable transaction” and “listed transaction” have the same meaning as previously described in connection with the taxpayer-related proposals.

regulations which provide that, in cases in which 2 or more persons are required to maintain the same list, only one person would be required to maintain the list.

Penalty for failing to maintain investor lists

The proposal modifies the penalty for failing to maintain the required list by making it a time-sensitive penalty. Thus, a material advisor who is required to maintain an investor list and who fails to make the list available upon request by the Secretary within 20 business days after the request will be subject to a \$10,000 per day penalty. The penalty applies to a person who fails to maintain a list, maintains an incomplete list, or has in fact maintained a list but does not make the list available to the Secretary. The penalty can be waived if the failure to make the list available is due to reasonable cause.¹⁰⁵

Effective Date

The proposal requiring a material advisor to maintain an investor list applies to transactions with respect to which material aid, assistance or advice is provided after the date of enactment.

The proposal imposing a penalty for failing to maintain investor lists applies to requests made after the date of enactment.

9. Actions to enjoin conduct with respect to tax shelters and reportable transactions

Present Law

The Code authorizes civil action to enjoin any person from promoting abusive tax shelters or aiding or abetting the understatement of tax liability.¹⁰⁶

Description of Proposal

The proposal expands this rule so that injunctions may also be sought with respect to the requirements relating to the reporting of reportable transactions¹⁰⁷ and the keeping of lists of investors by material advisors.¹⁰⁸ Thus, under the proposal, an injunction may be sought against a material advisor to enjoin the advisor from (1) failing to file an information return with respect

¹⁰⁵ In no event will failure to maintain a list be considered reasonable cause for failing to make a list available to the Secretary.

¹⁰⁶ Sec. 7408.

¹⁰⁷ Sec. 6707, as amended by other proposals of this bill.

¹⁰⁸ Sec. 6708, as amended by other proposals of this bill.

to a reportable transaction, or (2) failing to maintain, or to timely furnish upon written request by the Secretary, a list of investors with respect to each reportable transaction.

Effective Date

The proposal is effective on the day after the date of enactment.

10. Understatement of taxpayer's liability by income tax return preparer

Present Law

An income tax return preparer who prepares a return with respect to which there is an understatement of tax that is due to a position for which there was not a realistic possibility of being sustained on its merits and the position was not disclosed (or was frivolous) is liable for a penalty of \$250, provided that the preparer knew or reasonably should have known of the position. An income tax return preparer who prepares a return and engages in specified willful or reckless conduct with respect to preparing such a return is liable for a penalty of \$1,000.

Description of Proposal

The proposal alters the standards of conduct that must be met to avoid imposition of the first penalty. The proposal replaces the realistic possibility standard with a requirement that there be a reasonable belief that the tax treatment of the position was more likely than not the proper treatment. The proposal also replaces the not frivolous standard with the requirement that there be a reasonable basis for the tax treatment of the position.

In addition, the proposal increases the amount of these penalties. The penalty relating to not having a reasonable belief that the tax treatment was more likely than not the proper tax treatment is increased from \$250 to \$1,000. The penalty relating to willful or reckless conduct is increased from \$1,000 to \$5,000.

Effective Date

The proposal is effective for documents prepared after the date of enactment.

11. Penalty for failure to report interests in foreign financial accounts

Present Law

The Secretary of the Treasury must require citizens, residents, or persons doing business in the United States to keep records and file reports when that person makes a transaction or maintains an account with a foreign financial entity.¹⁰⁹ In general, individuals must fulfill this requirement by answering questions regarding foreign accounts or foreign trusts that are contained in Part III of Schedule B of the IRS Form 1040. Taxpayers who answer "yes" in response to the question regarding foreign accounts must then file Treasury Department Form

¹⁰⁹ 31 U.S.C. 5314.

TD F 90-22.1. This form must be filed with the Department of the Treasury, and not as part of the tax return that is filed with the IRS.

The Secretary of the Treasury may impose a civil penalty on any person who willfully violates this reporting requirement. The civil penalty is the amount of the transaction or the value of the account, up to a maximum of \$100,000; the minimum amount of the penalty is \$25,000.¹¹⁰ In addition, any person who willfully violates this reporting requirement is subject to a criminal penalty. The criminal penalty is a fine of not more than \$250,000 or imprisonment for not more than five years (or both); if the violation is part of a pattern of illegal activity, the maximum amount of the fine is increased to \$500,000 and the maximum length of imprisonment is increased to 10 years.¹¹¹

On April 26, 2002, the Secretary of the Treasury submitted to the Congress a report on these reporting requirements.¹¹² This report, which was statutorily required,¹¹³ studies methods for improving compliance with these reporting requirements. It makes several administrative recommendations, but no legislative recommendations. A further report is required to be submitted by the Secretary of the Treasury to the Congress by October 26, 2002.

Description of Proposal

The proposal adds an additional civil penalty that may be imposed on any person who violates this reporting requirement (without regard to willfulness). This new civil penalty is up to \$5,000. The penalty may be waived if any income from the account was properly reported on the income tax return and there was reasonable cause for the failure to report.

Effective Date

The proposal is effective with respect to failures to report occurring on or after the date of enactment.

¹¹⁰ 31 U.S.C. 5321(a)(5).

¹¹¹ 31 U.S.C. 5322.

¹¹² *A Report to Congress in Accordance with Sec. 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001*, April 26, 2002.

¹¹³ Sec. 361(b) of the USA PATRIOT Act of 2001 (Pub. L. 107-56).

12. Frivolous tax returns and submissions

Present Law

The Code provides that an individual who files a frivolous income tax return is subject to a penalty of \$500 imposed by the IRS (sec. 6702). The Code also permits the Tax Court¹¹⁴ to impose a penalty of up to \$25,000 if a taxpayer has instituted or maintained proceedings primarily for delay or if the taxpayer's position in the proceeding is frivolous or groundless (sec. 6673(a)).

Description of Proposal

The proposal modifies the IRS-imposed penalty by increasing the amount of the penalty to up to \$5,000 and by applying it to all taxpayers and to all types of Federal taxes.

The proposal also modifies present law with respect to certain submissions that raise frivolous arguments or that are intended to delay or impede tax administration. The submissions to which this proposal applies are requests for a collection due process hearing, installment agreements, offers-in-compromise, and taxpayer assistance orders. First, the proposal permits the IRS to dismiss such requests. Second, the proposal permits the IRS to impose a penalty of up to \$5,000 for such requests, unless the taxpayer withdraws the request after being given an opportunity to do so.

The proposal requires the IRS to publish a list of positions, arguments, requests, and proposals determined to be frivolous for purposes of these proposals.

Effective Date

The proposal is effective for submissions made and issues raised after the date on which the Secretary first prescribes the required list.

13. Regulation of individuals practicing before the Department of the Treasury

Present Law

The Secretary of the Treasury is authorized to regulate the practice of representatives of persons before the Department of the Treasury.¹¹⁵ The Secretary is also authorized to suspend or disbar from practice before the Department a representative who is incompetent, who is disreputable, who violates the rules regulating practice before the Department, or who (with intent to defraud) willfully and knowingly misleads or threatens the person being represented (or

¹¹⁴ Because in general the Tax Court is the only pre-payment forum available to taxpayers, it deals with most of the frivolous, groundless, or dilatory arguments raised in tax cases.

¹¹⁵ 31 U.S.C. 330.

a person who may be represented). The rules promulgated by the Secretary pursuant to this proposal are contained in Circular 230.

Description of Proposal

The proposal makes two modifications to expand the sanctions that the Secretary may impose pursuant to these statutory proposals. First, the proposal expressly permits censure as a sanction. Second, the proposal permits the imposition of a monetary penalty as a sanction. If the representative is acting on behalf of an employer or other entity, the Secretary may impose a monetary penalty on the employer or other entity if it knew, or reasonably should have known, of the conduct. This monetary penalty on the employer or other entity may be imposed in addition to any monetary penalty imposed directly on the representative. These monetary penalties are not to exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty. These monetary penalties may be in addition to, or in lieu of, any suspension, disbarment, or censure.

The proposal also confirms the present-law authority of the Secretary to impose standards applicable to written advice with respect to an entity, plan, or arrangement that is of a type that the Secretary determines as having a potential for tax avoidance or evasion.

Effective Date

The modifications to expand the sanctions that the Secretary may impose are effective for actions taken after the date of enactment.

14. Penalties on promoters of tax shelters

Present Law

A penalty is imposed on any person who organizes, assists in the organization of, or participates in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if in connection with such activity the person makes or furnishes a qualifying false or fraudulent statement or a gross valuation overstatement.¹¹⁶ A qualified false or fraudulent statement is any statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter. A “gross valuation overstatement” means any statement as to the value of any property or services if the stated value exceeds 200 percent of the correct valuation, and the value is directly related to the amount of any allowable income tax deduction or credit.

The amount of the penalty is \$1,000 (or, if the person establishes that it is less, 100 percent of the gross income derived or to be derived by the person from such activity). A penalty attributable to a gross valuation misstatement can be waived on a showing that there was a reasonable basis for the valuation and it was made in good faith.

¹¹⁶ Sec. 6700.

Description of Proposal

The proposal modifies the penalty amount to equal 50 percent of the gross income derived by the person from the activity for which the penalty is imposed. The new penalty rate applies to any activity that involves a statement regarding the tax benefits of participating in a plan or arrangement if the person knows or has reason to know that such statement is false or fraudulent as to any material matter. The enhanced penalty does not apply to a gross valuation overstatement.

Effective Date

The proposal is effective for activities after the date of enactment.

15. Extend statute of limitations for certain undisclosed transactions

Present Law

In general, the Code requires that taxes be assessed within three years¹¹⁷ after the date a return is filed.¹¹⁸ If there has been a substantial omission of items of gross income that total more than 25 percent of the amount of gross income shown on the return, the period during which an assessment must be made is extended to six years.¹¹⁹ If an assessment is not made within the required time periods, the tax generally cannot be assessed or collected at any future time. Tax may be assessed at any time if the taxpayer files a false or fraudulent return with the intent to evade tax or if the taxpayer does not file a tax return at all.¹²⁰

Description of Proposal

The proposal extends the statute of limitations to six years with respect to the entire tax return¹²¹ if a taxpayer required to disclose a listed transaction¹²² fails to do so in the manner required. For example, if a taxpayer entered into a transaction in 2001 that becomes a listed

¹¹⁷ Sec. 6501(a).

¹¹⁸ For this purpose, a return that is filed before the date on which it is due is considered to be filed on the required due date (sec. 6501(b)(1)).

¹¹⁹ Sec. 6501(e).

¹²⁰ Sec. 6501(c).

¹²¹ The tax year extended is the tax year the transaction is entered into.

¹²² The term “listed transaction” has the same meaning as described in a previous proposal regarding the penalty for failure to disclose reportable transactions.

transaction in 2002 and the taxpayer fails to disclose such transaction in the manner required by Treasury regulations, the 2001 tax return will be subject to a six-year statute of limitations.¹²³

Effective Date

The proposal is effective for transactions entered into in taxable years beginning after the date of enactment.

16. Deny deduction for interest paid to IRS on underpayments involving certain tax-motivated transactions

Present Law

In general, corporations may deduct interest paid or accrued within a taxable year on indebtedness.¹²⁴ Interest on indebtedness to the Federal government attributable to an underpayment of tax generally may be deducted pursuant to this provision.

Description of Proposal

The proposal disallows any deduction for interest paid or accrued within a taxable year on any portion of an underpayment of tax that is attributable to an understatement arising from (1) an undisclosed reportable avoidance transaction, (2) an undisclosed listed transaction, or (3) a transaction that lacks economic substance.¹²⁵

Effective Date

The proposal is effective for underpayments attributable to transactions entered into in taxable years beginning after the date of enactment.

¹²³ However, if the Treasury Department lists a transaction in a year subsequent to the year a taxpayer entered into such transaction, and the taxpayer's tax return for the year the transaction was entered into is closed by the statute of limitations prior to the transaction becoming a listed transaction, this proposal does not re-open the statute of limitations for such year.

¹²⁴ Sec. 163(a).

¹²⁵ The definitions of these transactions are the same as those previously described in connection with the proposal to modify the accuracy-related penalty for listed and certain reportable transactions and the proposal to impose a penalty on understatements attributable to transactions that lack economic substance.

17. Modify section 162(f) for certain fines and penalties

Present Law

Under present law, no deduction is allowed as a trade or business expense under section 162(a) for the payment of a fine or penalty to a government for the violation of any law (sec. 162(f)). The enactment of section 162(f) in 1969 codified existing case law that denied the deductibility of fines as ordinary and necessary business expenses on the grounds that “allowance of the deduction would frustrate sharply defined national or State policies proscribing the particular types of conduct evidenced by some governmental declaration thereof.”

Treasury regulation section 1.162-21(b)(1) provides that a fine or penalty includes an amount: (1) paid pursuant to conviction or a plea of guilty or *nolo contendere* for a crime (felony or misdemeanor) in a criminal proceeding; (2) paid as a civil penalty imposed by Federal, State, or local law, including additions to tax and additional amounts and assessable penalties imposed by chapter 68 of the Code; (3) paid in settlement of the taxpayer’s actual or potential liability for a fine or penalty (civil or criminal); or (4) forfeited as collateral posted in connection with a proceeding which could result in imposition of such a fine or penalty. Treasury regulation section 1.162-21(b)(2) provides, among other things, that compensatory damages (including damages under section 4A of the Clayton Act (15 U.S.C. 15a), as amended) paid to a government do not constitute a fine or penalty.

Description of Proposal

The proposal modifies the rules regarding the determination whether payments are nondeductible payments of fines or penalties under section 162(f). In particular, the proposal generally provides that amounts paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government in relation to the violation of any law or the investigation or inquiry into the potential violation of any law are nondeductible. The proposal applies to deny a deduction for any payments, including those where there is no admission of guilt or liability and those made for the purpose of avoiding further investigation or litigation. An exception applies to payments that the taxpayer establishes are restitution.

It is intended that a payment will be treated as restitution only if the payment is required to be paid to the specific persons, or in relation to the specific property, actually harmed by the conduct of the taxpayer that resulted in the payment. Thus, a payment to or with respect to a class broader than the specific persons or property that were actually harmed (for example, to a class including similarly situated persons or property) does not qualify as restitution. Restitution is limited to the amount that bears a substantial quantitative relationship to the harm caused by the past conduct or actions of the taxpayer that resulted in the payment in question. If the party harmed is a government or other entity, then restitution includes payment to such harmed government or entity, provided the payment bears a substantial quantitative relationship to the harm. However, restitution does not include reimbursement of government investigative or litigation costs, or payments to whistleblowers.

Any self-regulatory entity that regulates a financial market or other market that is a qualified board or exchange under section 1256(g)(7), and that imposes sanctions (as one

example, the National Association of Securities Dealers) is treated as a government for purposes of the proposal. To the extent provided in regulations, any other nongovernmental entity that exercises self-regulatory powers as part of performing an essential governmental function shall be treated as a government.

No inference is intended as to the treatment of payments as nondeductible fines or penalties under present law. In particular, the proposal is not intended to limit the scope of present-law section 162(f) or the regulations thereunder.

Effective Date

The proposal is effective for amounts paid or incurred after the date of enactment; however the proposal does not apply to fines or penalties imposed on or before such date or amounts paid or incurred under any agreement entered into on or before such date.

18. Authorize additional \$300 million per year to the IRS to combat abusive tax avoidance transactions

The proposal includes an authorization of an additional \$300 million to the Internal Revenue Service to be used to combat abusive tax avoidance transactions.

J. Other Provisions

1. Affirmation of consolidated return regulation authority

Present Law

An affiliated group of corporations may elect to file a consolidated return in lieu of separate returns. A condition of electing to file a consolidated return is that all corporations that are members of the consolidated group must consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for filing such return.¹²⁶

Section 1502 states:

The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent the avoidance of such tax liability.¹²⁷

Under this authority, the Treasury Department has issued extensive consolidated return regulations.¹²⁸

In the recent case of *Rite Aid Corp. v. United States*,¹²⁹ the Federal Circuit Court of Appeals addressed the application of a particular provision of certain consolidated return loss

¹²⁶ Sec. 1501.

¹²⁷ Sec. 1502.

¹²⁸ Regulations issued under the authority of section 1502 are considered to be “legislative” regulations rather than “interpretative” regulations, and as such are usually given greater deference by courts in case of a taxpayer challenge to such a regulation. *See*, S. Rep. No. 960, 70th Cong., 1st Sess. at 15, describing the consolidated return regulations as “legislative in character”. The Supreme Court has stated that “. . . legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute.” *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844 (1984) (involving an environmental protection regulation). For examples involving consolidated return regulations, *see, e.g., Wolter Construction Company v. Commissioner*, 634 F.2d 1029 (6th Cir. 1980); *Garvey, Inc. v. United States*, 1 Ct. Cl. 108 (1983), *aff’d* 726 F.2d 1569 (Fed. Cir. 1984), *cert. denied* 469 U.S. 823 (1984). *Compare, e.g., Audrey J. Walton v. Commissioner*, 115 T.C. 589 (2000), describing different standards of review. The case did not involve a consolidated return regulation.

¹²⁹ 255 F.3d 1357 (Fed. Cir. 2001), *reh’g denied*, 2001 U.S. App. LEXIS 23207 (Fed. Cir. Oct. 3, 2001).

disallowance regulations, and concluded that the provision was invalid.¹³⁰ The particular provision, known as the “duplicated loss” provision,¹³¹ would have denied a loss on the sale of stock of a subsidiary by a parent corporation that had filed a consolidated return with the subsidiary, to the extent the subsidiary corporation had assets that had a built-in loss, or had a net operating loss, that could be recognized or used later.¹³²

¹³⁰ Prior to this decision, there had been a few instances involving prior laws in which certain consolidated return regulations were held to be invalid. *See, e.g., American Standard, Inc. v. United States*, 602 F.2d 256 (Ct. Cl. 1979), discussed in the text *infra*. *see also Union Carbide Corp. v. United States*, 612 F.2d 558 (Ct. Cl. 1979), and *Allied Corporation v. United States*, 685 F. 2d 396 (Ct. Cl. 1982), all three cases involving the allocation of income and loss within a consolidated group for purposes of computation of a deduction allowed under prior law by the Code for Western Hemisphere Trading Corporations. *See also Joseph Weidenhoff v. Commissioner*, 32 T.C. 1222, 1242-1244 (1959), involving the application of certain regulations to the excess profits tax credit allowed under prior law, and concluding that the Commissioner had applied a particular regulation in an arbitrary manner inconsistent with the wording of the regulation and inconsistent with even a consolidated group computation. *Cf. Kanawha Gas & Utilities Co. v. Commissioner*, 214 F.2d 685 (1954), concluding that the substance of a transaction was an acquisition of assets rather than stock. Thus, a regulation governing basis of the assets of consolidated subsidiaries did not apply to the case. *See also General Machinery Corporation v. Commissioner*, 33 B.T.A. 1215 (1936); *Lefcourt Realty Corporation*, 31 B.T.A. 978 (1935); *Helvering v. Morgans, Inc.*, 293 U.S. 121 (1934), interpreting the term “taxable year.”

¹³¹ Treas. Reg. Sec. 1.1502-20(c)(1)(iii).

¹³² Treasury Regulation section 1.1502-20, generally imposing certain “loss disallowance” rules on the disposition of subsidiary stock, contained other limitations besides the “duplicated loss” rule that could limit the loss available to the group on a disposition of a subsidiary’s stock. Treasury Regulation section 1.1502-20 as a whole was promulgated in connection with regulations issued under section 337(d), principally in connection with the so-called *General Utilities* repeal of 1986 (referring to the case of *General Utilities & Operating Company v. Helvering*, 296 U.S. 200 (1935)). Such repeal generally required a liquidating corporation, or a corporation acquired in a stock acquisition treated as a sale of assets, to pay corporate level tax on the excess of the value of its assets over the basis. Treasury regulation section 1.1502-20 principally reflected an attempt to prevent corporations filing consolidated returns from offsetting income with a loss on the sale of subsidiary stock. Such a loss could result from the unique upward adjustment of a subsidiary’s stock basis required under the consolidated return regulations for subsidiary income earned in consolidation, an adjustment intended to prevent taxation of both the subsidiary and the parent on the same income or gain. As one example, absent a denial of certain losses on a sale of subsidiary stock, a consolidated group could obtain a loss deduction with respect to subsidiary stock, the basis of which originally reflected the subsidiary’s value at the time of the purchase of the stock, and that had then been adjusted upward on recognition of any built-in income or gain of the subsidiary reflected in that value. The regulations also contained the duplicated loss factor addressed by the court in *Rite Aid*. The preamble to the regulations stated: “it is not administratively feasible to differentiate

The Federal Circuit Court opinion contained language discussing the fact that the regulation produced a result different than the result that would have obtained if the corporations had filed separate returns rather than consolidated returns.¹³³

The Federal Circuit Court opinion cited a 1928 Senate Finance Committee Report to legislation that authorized consolidated return regulations, which stated that “many difficult and complicated problems, ... have arisen in the administration of the provisions permitting the filing of consolidated returns” and that the committee “found it necessary to delegate power to the commissioner to prescribe regulations legislative in character covering them.”¹³⁴ The Court’s opinion also cited a previous decision of the Court of Claims for the proposition, interpreting this legislative history, that section 1502 grants the Secretary “the power to conform the applicable income tax law of the Code to the special, myriad problems resulting from the filing of consolidated income tax returns;” but that section 1502 “does not authorize the Secretary to choose a method that imposes a tax on income that would not otherwise be taxed.”¹³⁵

between loss attributable to built-in gain and duplicated loss.” T.D. 8364, 1991-2 C.B. 43, 46 (Sept. 13, 1991). The government also argued in the *Rite Aid* case that duplicated loss was a separate concern of the regulations. 255 F.3d at 1360.

¹³³ For example, the court stated: “The duplicated loss factor . . . addresses a situation that arises from the sale of stock regardless of whether corporations file separate or consolidated returns. With I.R.C. secs. 382 and 383, Congress has addressed this situation by limiting the subsidiary’s potential future deduction, not the parent’s loss on the sale of stock under I.R.C. sec. 165.” 255 F.3d 1357, 1360 (Fed. Cir. 2001).

¹³⁴ S. Rep. No. 960, 70th Cong., 1st Sess. 15 (1928). Though not quoted by the court in *Rite Aid*, the same Senate report also indicated that one purpose of the consolidated return authority was to permit treatment of the separate corporations as if they were a single unit, stating “The mere fact that by legal fiction several corporations owned by the same shareholders are separate entities should not obscure the fact that they are in reality one and the same business owned by the same individuals and operated as a unit.” S. Rep. No. 960, 70th Cong., 1st Sess. 29 (1928).

¹³⁵ *American Standard, Inc. v. United States*, 602 F.2d 256, 261 (Ct. Cl. 1979). That case did not involve the question of separate returns as compared to a single return approach. It involved the computation of a Western Hemisphere Trade Corporation (“WHTC”) deduction under prior law (which deduction would have been computed as a percentage of each WHTC’s taxable income if the corporations had filed separate returns), in a case where a consolidated group included several WHTCs as well as other corporations. The question was how to apportion income and losses of the admittedly consolidated WHTCs and how to combine that computation with the rest of the group’s consolidated income or losses. The court noted that the new, changed regulations approach varied from the approach taken to a similar problem involving public utilities within a group and previously allowed for WHTCs. The court objected that the allocation method adopted by the regulation allowed non-WHTC losses to reduce WHTC income. However, the court did not disallow a method that would net WHTC income of one WHTC with losses of another WHTC, a result that would not have occurred under separate

The Federal Circuit Court construed these authorities and applied them to invalidate Treas. Reg. Sec. 1.1502-20(c)(1)(iii), stating that:

The loss realized on the sale of a former subsidiary's assets after the consolidated group sells the subsidiary's stock is not a problem resulting from the filing of consolidated income tax returns. The scenario also arises where a corporate shareholder sells the stock of a non-consolidated subsidiary. The corporate shareholder could realize a loss under I.R.C. sec. 1001, and deduct the loss under I.R.C. sec. 165. The subsidiary could then deduct any losses from a later sale of assets. The duplicated loss factor, therefore, addresses a situation that arises from the sale of stock regardless of whether corporations file separate or consolidated returns. With I.R.C. secs. 382 and 383, Congress has addressed this situation by limiting the subsidiary's potential future deduction, not the parent's loss on the sale of stock under I.R.C. sec. 165.¹³⁶

The Treasury Department has announced that it will not continue to litigate the validity of the duplicated loss provision of the regulations, and has issued interim regulations that permit taxpayers for all years to elect a different treatment, though they may apply the provision for the past if they wish.¹³⁷

Description of Proposal

The proposal confirms that, in exercising its authority under section 1502 to issue consolidated return regulations, the Treasury Department may provide rules treating corporations filing consolidated returns differently from corporations filing separate returns.

Thus, under the statutory authority of section 1502, the Treasury Department is authorized to issue consolidated return regulations utilizing either a single taxpayer or separate taxpayer approach or a combination of the two approaches, as Treasury deems necessary in order that the tax liability of any affiliated group of corporations making a consolidated return, and of each corporation in the group, both during and after the period of affiliation, may be determined

returns. Nor did the court expressly disallow a different fractional method that would net both income and losses of the WHTCs with those of other corporations in the consolidated group. The court also found that the regulation had been adopted without proper notice.

¹³⁶ *Rite Aid*, 255 F.3d at 1360.

¹³⁷ *See* Temp. Reg. 1.1502-20T(i)(2). The Treasury Department has also indicated its intention to continue to study all the issues that the original loss disallowance regulations addressed (including issues of furthering single entity principles) and possibly issue different regulations (not including the particular approach of Treas. Reg. Sec. 1.1502-20(c)(1)(iii)) on the issues in the future. *See* Notice 2002-11, 2002-7 I.R.B. 526 (Feb. 19, 2002); T.D. 8984, 67 F.R. 11034 (March 12, 2002); REG-102740-02, 67 F.R. 11070 (March 12, 2002); *see also* Notice 2002-18, 2002-12 I.R.B. 644 (March 25, 2002).

and adjusted in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such liability.

Rite Aid is thus overruled to the extent it suggests that there is not a problem that can be addressed in consolidated return regulations if application of a particular Code provision on a separate taxpayer basis would produce a result different from single taxpayer principles that may be used for consolidation.

The proposal nevertheless allows the result of the *Rite Aid* case to stand with respect to the type of factual situation presented in the case. That is, the legislation provides for the override of the regulatory provision that took the approach of denying a loss on a deconsolidating disposition of stock of a consolidated subsidiary¹³⁸ to the extent the subsidiary had net operating losses or built in losses that could be used later outside the group.¹³⁹

Retaining the result in the *Rite Aid* case with respect to the particular regulation section 1.1502-20(c)(1)(iii) as applied to the factual situation of the case does not in any way prevent or invalidate the various approaches Treasury has announced it will apply or that it intends to consider in lieu of the approach of that regulation, including, for example, the denial of a loss on a stock sale if inside losses of a subsidiary may also be used by the consolidated group, and the possible requirement that inside attributes be adjusted when a subsidiary leaves a group.¹⁴⁰

Effective Date

The proposal is effective for all years, whether beginning before, on, or after the date of enactment of the proposal.

No inference is intended that the results following from this proposal are not the same as the results under present law.

¹³⁸ Treas. Reg. Sec. 1.1502-20(c)(1)(iii).

¹³⁹ The proposal is not intended to overrule the current Treasury Department regulations, which allow taxpayers for the past to follow Treasury Regulations Section 1.1502-20(c)(1)(iii), if they choose to do so. Temp. Reg. Sec. 1.1502-20T(i)(2).

¹⁴⁰ See, e.g., Notice 2002-11, 2002-7 I.R.B. 526 (Feb. 19, 2002); T.D. 8984, 67 F.R. 11034 (Mar.12, 2002); REG-102740-02, 67 F.R. 11070 (Mar.12, 2002); see also Notice 2002-18, 2002-12 I.R.B. 644 (Mar. 25, 2002). In exercising its authority under section 1502, the Secretary is also authorized to prescribe rules that protect the purpose of *General Utilities* repeal using presumptions and other simplifying conventions.

K. Provisions Relating to Fair Taxation of Executive Compensation

1. Taxation of deferred compensation provided through offshore trusts

Present Law

The determination of when amounts deferred under a nonqualified deferred compensation arrangement are includible in the gross income of the individual earning the compensation depends on the facts and circumstances of the arrangement. A variety of tax principles and Code provisions may be relevant in making this determination, including the doctrine of constructive receipt, the economic benefit doctrine,¹⁴¹ the provisions of section 83 relating generally to transfers of property in connection with the performance of services, and provisions relating specifically to nonexempt employee trusts (sec. 402(b)) and nonqualified annuities (sec. 403(c)).

In general, the time for inclusion of nonqualified deferred compensation depends on whether the arrangement is unfunded or funded. If the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received (i.e., when it is paid or otherwise made available). If the arrangement is funded, then income is includible for the year in which the individual's rights are transferable or not subject to a substantial risk of forfeiture.

Nonqualified deferred compensation is generally subject to social security and Medicare tax when it is earned (i.e., when services are performed), unless the nonqualified deferred compensation is subject to a substantial risk of forfeiture. If nonqualified deferred compensation is subject to a substantial risk of forfeiture, it is subject to social security and Medicare tax when the risk of forfeiture is removed (i.e., when the right to the nonqualified deferred compensation vests). This treatment is not affected by whether the arrangement is funded or unfunded, which is relevant in determining when amounts are includible in income (and subject to income tax withholding).

In general, an arrangement is considered funded if there has been a transfer of property under section 83. Under that section, a transfer of property occurs when a person acquires a beneficial ownership interest in such property. The term "property" is defined very broadly for purposes of section 83.¹⁴² Property includes real and personal property other than money or an unfunded and unsecured promise to pay money in the future. Property also includes a beneficial interest in assets (including money) that are transferred or set aside from claims of the creditors of the transferor, for example, in a trust or escrow account. Accordingly, if, in connection with the performance of services, vested contributions are made to a trust on an individual's behalf and the trust assets may be used solely to provide future payments to the individual, the payment of the contributions to the trust constitutes a transfer of property to the individual that is taxable under section 83. On the other hand, deferred amounts are generally not includible in income in

¹⁴¹ See, e.g., *Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952); Rev. Rul. 60-31, 1960-1 C.B. 174.

¹⁴² Treas. Reg. sec. 1.83-3(e). This definition in part reflects previous IRS rulings on nonqualified deferred compensation.

situations where nonqualified deferred compensation is payable from general corporate funds that are subject to the claims of general creditors, as such amounts are treated as unfunded and unsecured promises to pay money or property in the future.

Rabbi trusts

Arrangements have developed in an effort to provide employees with security for nonqualified deferred compensation, while still allowing deferral of income inclusion. A “rabbi trust” is a trust or other fund established by the employer to hold assets from which nonqualified deferred compensation payments will be made. The trust or fund is generally irrevocable and does not permit the employer to use the assets for purposes other than to provide nonqualified deferred compensation. However, the terms of the trust or fund provide that the assets are subject to the claims of the employer’s creditors in the case of bankruptcy or insolvency.

As discussed above, for purposes of section 83, property includes a beneficial interest in assets set aside from the claims of creditors, such as in a trust or fund, but does not include an unfunded and unsecured promise to pay money in the future. In the case of a rabbi trust, terms providing that the assets are subject to the claims of creditors of the employer in the case of bankruptcy or insolvency have been the basis for the conclusion that the creation of a rabbi trust does not cause the related nonqualified deferred compensation arrangement to be funded for income tax purposes.¹⁴³ As a result, no amount is included in income by reason of the rabbi trust; generally income inclusion occurs as payments are made from the trust.

The IRS has issued guidance setting forth model rabbi trust provisions.¹⁴⁴ Revenue Procedure 92-64 provides a safe harbor for taxpayers who adopt and maintain grantor trusts in connection with unfunded deferred compensation arrangements. The model trust language requires that the trust provide that all assets of the trust are subject to the claims of the general creditors of the company in the event of the company’s insolvency or bankruptcy.

Since the concept of rabbi trusts was developed, arrangements have developed which attempt to protect the assets from creditors despite the terms of the trust. Arrangements also have developed which effectively allow deferred amounts to be available to individuals, while still meeting the safe harbor requirements set forth by the IRS.

Description of Proposal

The proposal provides that assets that are designated or otherwise available for the use of providing nonqualified deferred compensation and are located outside the United States (e.g., in a foreign trust, arrangement or account) are not treated as subject to the claims of general creditors. Therefore, to the extent of such assets, nonqualified deferred compensation amounts

¹⁴³ This conclusion was first provided in a 1980 private ruling issued by the IRS with respect to an arrangement covering a rabbi; hence the popular name “rabbi trust.” Priv. Ltr. Rul. 8113107 (Dec. 31, 1980).

¹⁴⁴ Rev. Proc. 92-64, 1992-2 C.B. 422, modified in part by Notice 2000-56, 2000-2 C.B. 393.

are not treated as unfunded and unsecured promises to pay, but are treated as property under section 83 and includible in income when the right to the compensation is no longer subject to a substantial risk of forfeiture, regardless of when the compensation is paid. No inference is intended that nonqualified deferred compensation assets located outside of the U.S. would be treated as subject to the claims of creditors under present law.

The proposal does not apply to assets located in a foreign jurisdiction if substantially all of the services to which the nonqualified deferred compensation relates are performed in such foreign jurisdiction.

The proposal is specifically intended to apply to foreign trusts and arrangements that effectively shield from the claims of general creditors any assets intended to satisfy nonqualified deferred compensation obligations. The proposal provides the Secretary of the Treasury authority to prescribe regulations as are necessary to carry out the proposal and to provide additional exceptions for specific arrangements which do not result in improper deferral of U.S. tax if the assets involved in the arrangement are readily accessible in any insolvency or bankruptcy proceeding.

Effective Date

The proposal is effective for amounts deferred after December 31, 2002.

2. Repeal of limitation on issuance of Treasury guidance regarding nonqualified deferred compensation

Present Law

General tax treatment of nonqualified deferred compensation

The determination of when amounts deferred under a nonqualified deferred compensation arrangement are includible in the gross income of the individual earning the compensation depends on the facts and circumstances of the arrangement. A variety of tax principles and Code provisions may be relevant in making this determination, including the doctrine of constructive receipt, the economic benefit doctrine, the provisions of section 83 relating generally to transfers of property in connection with the performance of services, and provisions relating specifically to nonexempt employee trusts (sec. 402(b)) and nonqualified annuities (sec. 403(c)).

In general, the time for inclusion of nonqualified deferred compensation depends on whether the arrangement is unfunded or funded. If the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received. If the arrangement is funded, then income is includible for the year in which the individual's rights are transferable or not subject to a substantial risk of forfeiture.

In general, an arrangement is considered funded if there has been a transfer of property under section 83. Under that section, a transfer of property occurs when a person acquires a beneficial ownership interest in such property. The term "property" is defined very broadly for

purposes of section 83.¹⁴⁵ Property includes real and personal property other than money or an unfunded and unsecured promise to pay money in the future. Property also includes a beneficial interest in assets (including money) that are transferred or set aside from claims of the creditors of the transferor, for example, in a trust or escrow account. Accordingly, if, in connection with the performance of services, vested contributions are made to a trust on an individual's behalf and the trust assets may be used solely to provide future payments to the individual, the payment of the contributions to the trust constitutes a transfer of property to the individual that is taxable under section 83. On the other hand, deferred amounts are generally not includible in income in situations where nonqualified deferred compensation is payable from general corporate funds that are subject to the claims of general creditors, as such amounts are treated as unfunded and unsecured promises to pay money or property in the future.

As discussed above, if the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received under section 451. Income is constructively received when it is credited to an individual's account, set apart, or otherwise made available so that it can be drawn on at any time. Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. A requirement to relinquish a valuable right in order to make withdrawals is generally treated as a substantial limitation or restriction.

Special statutory provisions govern the timing of the deduction for nonqualified deferred compensation, regardless of whether the arrangement covers employees or nonemployees and regardless of whether the arrangement is funded or unfunded.¹⁴⁶ Under these provisions, the amount of nonqualified deferred compensation that is includible in the income of the individual performing services is deductible by the service recipient for the taxable year in which the amount is includible in the individual's income.

Rulings on nonqualified deferred compensation

In the 1960's and early 1970's, various IRS revenue rulings considered the tax treatment of nonqualified deferred compensation arrangements.¹⁴⁷ Under these rulings, a mere promise to pay, not represented by notes or secured in any way, was not regarded as the receipt of income for tax purposes. However, if an amount was contributed to an escrow account or trust on the individual's behalf, to be paid to the individual in future years with interest, the amount was held to be includible in income under the economic benefit doctrine. Deferred amounts were not currently includible in income in situations in which nonqualified deferred compensation was payable from general corporate funds that were subject to the claims of general creditors and the plan was not funded by a trust, or any other form of asset segregation to which individuals had

¹⁴⁵ Treas. Reg. sec. 1.83-3(e). This definition in part reflects previous IRS rulings on nonqualified deferred compensation.

¹⁴⁶ Secs. 404(a)(5), (b) and (d) and sec. 83(h).

¹⁴⁷ The seminal ruling dealing with nonqualified deferred compensation is Rev. Rul. 60-31, 1960-1 C.B. 174.

any prior or privileged claim.¹⁴⁸ Similarly, current income inclusion did not result when the employer purchased an annuity contract to provide a source of funds for its deferred compensation liability if the employer was the applicant, owner and beneficiary of the annuity contract, and the annuity contract was subject to the general creditors of the employer.¹⁴⁹ In these situations, deferred compensation amounts were held to be includible in income when actually received or otherwise made available.

Proposed Treasury regulation 1.61-16, published in the Federal Register for February 3, 1978, provided that if a payment of an amount of a taxpayer's compensation is, at the taxpayer's option, deferred to a taxable year later than that in which such amount would have been payable but for his exercise of such option, the amount shall be treated as received by the taxpayer in such earlier taxable year.¹⁵⁰

Section 132 of the Revenue Act of 1978

Section 132 of the Revenue Act of 1978¹⁵¹ was enacted in response to proposed Treasury regulation 1.61-16. Section 132 of the Revenue Act of 1978 provides that the taxable year of inclusion in gross income of any amount covered by a private deferred compensation plan is determined in accordance with the principles set forth in regulations, rulings, and judicial decisions relating to deferred compensation which were in effect on February 1, 1978. The term, "private deferred compensation plan" means a plan, agreement, or arrangement under which the person for whom service is performed is not a State or a tax-exempt organization and under which the payment or otherwise making available of compensation is deferred. However, the provision does not apply to certain employer-provided retirement arrangements (e.g., a qualified retirement plan), a transfer of property under section 83, or an arrangement that includes a nonexempt employees trust under section 402(b). Section 132 was not intended to restrict judicial interpretation of the law relating to the proper tax treatment of deferred compensation or interfere with judicial determinations of what principles of law apply in determining the timing of income inclusion.

Description of Proposal

The proposal repeals section 132 of the Revenue Act of 1978. It is intended that the Secretary of the Treasury issue guidance with respect to the tax treatment of nonqualified deferred compensation arrangements focusing on arrangements that improperly defer income. For example, it is intended that the Secretary address what is considered a substantial limitation

¹⁴⁸ Rev. Rul. 69-650, 1969-2 C.B. 106; Rev. Rul. 69-49, 1969-1 C.B. 138.

¹⁴⁹ Rev. Rul. 72-25, 1972-1 C.B. 127. *See also*, Rev. Rul. 68-99, 1968-1 C.B. 193, in which the employer's purchase of an insurance contract on the life of the employee did not result in an economic benefit to the employee if all rights to any benefits under the contract were solely the property of the employer and the proceeds of the contract were payable only to the employer.

¹⁵⁰ Prop. Treas. Reg. 1.61-16, 43 Fed. Reg. 4638 (1978).

¹⁵¹ Pub. L. No. 95-600.

under the constructive receipt doctrine and situations in which an individual's right to receive compensation is, at least in form, subject to substantial limitations, but in fact is not so limited. It is also intended that the Secretary address arrangements which purport to not be funded, but should be treated as funded. In addition, it is intended that the Secretary address arrangements in which assets, by the technical terms of the arrangements, appear to be subject to the claims of an employer's general creditors, but practically are unavailable to creditors. Arrangements that the Secretary is expected to address include the following: the ability to receive funds on account of financial hardship, the use of trusts or other arrangements under which the rights of general creditors to gain access to funds is limited, the use of triggers and third-party guarantees to fund arrangements, and the ability to receive funds subject to a forfeiture of some portion of the participant's deferred compensation (often referred to as a "haircut"). It is intended that such future guidance be consistent with the executive compensation provisions of the bill.

It is not intended that the Secretary take the position (as taken in proposed Treasury regulation 1.61-16) that all elective nonqualified deferred compensation is currently includible in income.

No inference is intended that the Secretary is prohibited under present law from issuing guidance with respect to nonqualified deferred compensation arrangements or that any existing nonqualified deferred compensation guidance issued by the Secretary is invalid. In addition, no inference is intended that any arrangements covered by future guidance provide permissible deferrals of income under present law.

Effective Date

The proposal is effective for taxable years beginning after the date of enactment.

3. Required wage withholding at top marginal rate for supplemental wage payments in excess of \$1 million

Present Law

An employer must withhold income taxes from wages paid to employees; there are several possible methods for determining the amount of income tax to be withheld. The IRS publishes tables (Publication 15, "Circular E") to be used in determining the amount of income tax to be withheld. The tables generally reflect the income tax rates under the Code so that withholding approximates the ultimate tax liability with respect to the wage payments. In some cases, "supplemental" wage payments (e.g., bonuses or commissions) may be subject to withholding at a flat rate¹⁵², based on the third lowest income tax rate under the Code (27 percent for 2002).¹⁵³

¹⁵² See section 13273 of the Revenue Reconciliation Act of 1993.

¹⁵³ See section 101(c)(11) of the Economic Growth and Tax Relief Reconciliation Act of 2001.

Description of Proposal

Under the proposal, once annual supplemental wage payments to an employee exceed \$1 million, any additional supplemental wage payments to the employee in that year are subject to withholding at the highest income tax rate (38.6 percent for 2002), regardless of any other withholding rules and regardless of the employee's Form W-4.

This rule applies only for purposes of wage withholding; other types of withholding (such as pension withholding and backup withholding) are not affected.

Effective Date

The proposal is effective with respect to wage payments made after December 31, 2002.